

INTERNATIONAL MONETARY POLICY

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BY

W. M. SCAMMELL

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*To the
memory of my mother*

'The time will come at which it will be thought as unreasonable for any country to regulate its currency without reference to other countries as it will be to have signalling codes at sea which take no account of the signalling codes at sea of other countries.'

ALFRED MARSHALL

PREFACE

Prefaces are written last and, as I end this book by writing its beginning, I am conscious that many persons and influences have contributed to its form and ideas. The main intellectual debts have, I hope, been acknowledged in the text but it is impossible to write on such a subject as this without assimilating much from the work of others which is valuable yet which cannot be directly acknowledged — ideas from one's reading and from discussion with friends. More immediately my thanks are due to Professor Duncan Black for reading an early draft and making useful suggestions for its improvement; to Mr. J. Johnston of the University of Manchester for many suggestions and constructive criticism of the theory chapters; to the University College of North Wales for a period of leave during which the first draft was written and for a generous grant of research funds; and to my wife, whose long-suffering patience has endured this thing about the house for so long and without whose help the book would not have been written.

Neither the facts nor the views expressed in the book reflect my present official position at the Treasury.

W. M. SCAMMELL

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ABBREVIATIONS

BIS	Bank for International Settlements
CEEC	Committee for European Economic Co-operation
ECA	Economic Co-operation Administration
ECE	Economic Commission for Europe
ECOSOC	Economic and Social Council of the United Nations
EPU	European Payments Union
ERP	European Recovery Programme
GATT	General Agreement on Tariffs and Trade
ICA	International Co-operation Administration
IMF	International Monetary Fund
ITO	International Trade Organisation
IBRD or World Bank	} International Bank for Reconstruction and Development
IFC	
MSA	Mutual Security Agency
OEEC	Organisation for European Economic Co-operation
OSA	Overseas Sterling Area
RSA	Rest of Sterling Area
UN	United Nations
UNRRA	United Nations Relief and Rehabilitation Administration

SECTION I

‘As a banker writes, only touching the needful.’

WALTER SCOTT, *The Fortunes of Nigel*

INTRODUCTION

THE object of this study is to consider international monetary policy since 1945 and in particular the experiments in international monetary co-operation which have been made during the last decade. In 1944 the United Nations Monetary and Financial Conference at Bretton Woods produced the most ambitious plan for the world economy which had ever been made. This plan not only provided for institutions to deal with international currency stabilisation and with international investment, but it was to be the first of a series of plans in which others would provide for commercial policy and international measures for full employment. Only the Bretton Woods proposals survived the planning stage and were implemented. The Havana Charter, embodying the scheme for an International Trade Organisation, was never ratified by the member nations and, although much has been written on the problem of international full employment and several draft schemes have been prepared, no formal international co-operative arrangements exist. It is our purpose to consider the problem of international monetary policy and co-operation; to assess the worth and the record of the payments system which was born at Bretton Woods; and to consider some of the *ad hoc* experiments in monetary co-operation which have been made since the war. In posing once more the questions of 1944, and in examining the answers which were given, there is no telling what interesting supplementaries may be raised.

The international economy in 1945 was such as to daunt the most optimistic and ardent planner. Six years of war had shattered the political and economic relationships which had made up the world economy of 1939; the productive power of Europe had been destroyed or curtailed while that of the United States had been enhanced; debtor/creditor relationships had been fundamentally altered; direct controls on the passage of goods and the exchange of

currencies had replaced the old régime of convertible currencies and multilateral trade; while, over large sections of the world, five years of deferred consumption and retarded investment made clamant calls upon diminished productive resources. All this was but the immediate problem. The problem of creating a stable system of world payments remained where it had been set down in 1939; the needs of the backward regions of the world for development pressed hard on the economies of the mature countries; and the economic and social disease of involuntary unemployment, whose ravages the war had arrested, seemed a danger to be reckoned with.

Four main tasks demanded attention. First, the immediate needs of physical reconstruction and rehabilitation had to be met. If disease, starvation and political anarchy were not to spread over the European and Asiatic countries in which war had been waged this was an immediate claim on all countries capable of producing a surplus over their current needs. Once the immediate physical requirements had been met there remained the longer and more difficult task of restoring stable currencies and trade relationships, so that trade could expand progressively as production was restored.

Second, there was the task of establishing and maintaining international payments equilibrium. Since the breakdown of the gold standard in the 'thirties the world had been moving towards a new form of payments system. A first step towards more far-reaching monetary co-operation had been taken in 1936 with the conclusion between the United States, France and Great Britain of the Tri-Partite Monetary Agreement, but the task of continuing that progress, and adapting it to the changed circumstances wrought by the war had now to be faced. Earlier systems of adjustment had required that domestic income and prices should be varied in the interests of the balance of payments. Now, in a world in which nations demanded the right to stabilise income and prices at the level appropriate to full employment of resources, the problem had to be viewed afresh.

Thirdly, there was the problem of stable employment. During the interwar years involuntary unemployment had been the greatest economic and social problem of the times, reducing national incomes, causing misery and poverty and bedevilling industrial relations in every country. Imperfectly understood by econo-

mists and politicians the disease had raged unchecked. In Britain during the depression of 1929-33 unemployment had been as high as 22 per cent of the working population;¹ never between the wars had the number of British unemployed fallen below a million. In Germany and the United States the problem had been worse. To remove unemployment by appropriate domestic policy and to establish international means of preventing the spread of recession from one country to another was a *sine qua non* of an ordered and stable world economy.

And fourthly, there was the problem of establishing a stable structure of world trade. During the nineteenth century and again during the interwar years multilateral trade and convertible currencies had facilitated general world trading. In Victorian times Britain's position as a creditor nation had enabled her to keep up a steady flow of overseas investment in primary-commodity producing countries whose products she had need of for food and raw materials. This willingness to lend and readiness to import had prevented a 'sterling shortage'. Sterling was the supreme world currency and the bill on London the predominant means of financing international trade. The First World War did much to undermine this structure. The United States became a creditor country and Britain a debtor. Although conscious of her obligations the United States did not lend abroad in any significant amount — worse, her lending was irregular and uncertain. Moreover, she remained a protectionist country and with this, and the enormous domestic production of primary and secondary products with which exporters had to compete, it was difficult to prevent recurring shortages of dollar currency. Such shortages were only prevented by the large imports into the United States of certain basic raw materials from countries with whom the European manufacturing nations had surpluses. On a basis of triangular trade the payments system of the interwar years limped badly, but at least it could limp. There was, in 1945, the certainty that in the postwar period a new structure of world trade would have to be pioneered. The creditor position of the United States with its gigantic and diverse production and large exportable surplus had now become the central problem in such a task.

¹ This figure is an average for the whole country in 1932. In certain areas, e.g., South Wales and the North East coast the rate of unemployment was over 30 per cent.

There was, in 1945, general recognition of the need to seek solutions to such problems as these by means of international co-operation, rather than by unco-ordinated unilateral action. The sense of unified purpose which the war-effort of the United Nations had bred; the sense of the enormity of the tasks to be faced and the uselessness of stop-gap measures to meet them, in part accounted for this upsurge of the will to co-operate. But there were more deep-seated reasons. After all nations do not lose their heads in a spasm of emotional fervour, and deep-rooted antipathies and policies do not disappear even in the first flush of victory. Long months of effort and planning on complex matters can only be sustained by fixity of purpose.

Probably the greatest contribution to postwar co-operation came from the changed attitude of the United States. Since the 'thirties a complete *volte face* in the foreign economic policy of that country had taken place. During the 'twenties American policy had been isolationist in the extreme. At the Versailles Conference the economic issues had been swept to one side and in the years that followed there had been scant regard for the destabilising role of war debts in the world economy or for the effect of American tariffs on depressed European industries. In 1933 the dollar had been depreciated and Roosevelt administered the *coup de grâce* to the London Economic Conference. Yet by 1943 American plans for currency stabilisation were being prepared and the American Treasury was making the pace towards their implementation.¹ Not only did this mean that the weight of the United States would be thrown on the side of a planned international economy but the spectacle of it provided encouragement to other nations, who might otherwise have been timorous. It was felt that at last America was growing up and becoming conscious of her economic leadership and responsibilities.

The cause of international co-operation was also strengthened by an increasing acceptance of the idea of economic planning. Even in those economies, such as the United States, which claimed to be competitive and to apply the principle of private economic enterprise, large sectors of the economy were under the control of government or of governmental agencies and the principle of economic planning was widely accepted. Moreover, in a world

¹ An encouraging preliminary was the lead taken by the United States in the foundations and financing of UNRRA.

where economic policy had become the prerogative of government and was often the tool of national aspirations the potential clash of governmental will in the international economy was great and was a source of instability and uncertainty. If it is true to say that an increase in the scope of national planning had meant an increase in international instability, then this in its turn demanded planning in the international sphere. This fact was accepted. Moreover, the international co-operation which it made possible was of a different order from that which had taken place in the interwar period, when such co-operation as had taken place had been directed towards specific limited objectives as, for example, the stabilisation loans of the League of Nations which were designed to give support to certain Central European currencies; or the Brussels and Genoa Conferences which sought to find a way back to the gold standard; or the creation of the Bank for International Settlements which the Young Committee regarded as a contribution towards the solution of the problem of German reparations. Now the aim of co-operation was to be general, rather than specific and its scope was to include monetary, commercial and anti-cyclical planning.

Common purpose, such as motivated the United Nations in 1944, requires also an agreed body of knowledge by relation to which conditions may be analysed and an approach to reconstruction formulated. In part the failure to co-operate successfully for the solution of economic and monetary problems in the 'thirties was due to the diversity of approach, nay the bewilderment, in face of the great depression and the breakdown of a payments system which had endured for more than a century.¹ Between 1936 and 1944, however, economic knowledge had increased. Income analysis had thrown light upon the forces determining the level of income and employment; the dynamics of the business cycle was better understood; the relationship of the balance of payments to domestic income and prices was established and the processes of international adjustment were being subjected to scrutiny. All this had had its effect upon policy. As the classical confidence in the price system had faded monetary policy had given way to the fiscal

¹ Consider for example the London Economic Conference of 1933 at which so many solutions to the problem of depression and unemployment were canvassed. To the United States the problem was how to raise prices; to France it appeared necessary to keep prices low. Britain, who through Neville Chamberlain preached the necessity of public expenditures at the Conference, practised the most stringent economies at home. There was at the Conference no set of agreed principles or accepted procedures around which policies could fructify.

policies dictated by income analysis as main regulators of the tempo of economic activity. Spurred by necessity, governments had been ready to act on new economic knowledge and the Second World War had provided the means of trying and testing the new concepts in practice. It was now generally accepted that in the post-war world a high and stable level of employment would be the major policy determinant for the great powers and there was general agreement as to the means by which this end should be pursued. Similarly with regard to exchange rates it was agreed that disturbing fluctuations should be avoided. The gold standard, at least in a rigid form, was inappropriate to modern world conditions. All this provided a basis of common thought around which efforts for international economic co-operation could rally.

Yet in spite of all these factors to encourage co-operation there were many difficulties still to overcome. Perhaps the most potent lay in the inevitable clash of domestic economic policy and action dictated by international stability. The effects of domestic policies are, after all, more immediate and more easily observable than their repercussions on the world at large, and the temptation is great for governments to follow lines of action pleasing to their electorates, whatever may be the international consequences. Under the gold standard it was taken for granted that domestic stability should be subordinate to external stability: later the world reversed the order of precedence.

It is inevitable that individual nations in their approach to international monetary planning should be influenced by their own economic aspirations. It is best to be realistic and to admit that unless a satisfactory answer can be given to the question 'what is there in this for us?' co-operation will be, at best, ephemeral. In any international gathering, be it *ad hoc* committee, conference, or permanent body, some means must be found of sinking divergent national policies in the general aims of the group. In an international institution for currency stabilisation the views of new countries, old countries, self-supporting and importing countries, primary producers and industrial producers, debtors and creditors, great powers and tiny states must all be fused. This is not an easy task. It is certain from time to time to involve sacrifice on somebody's part and an infinite genius for compromise.

In the furtherance of international co-operation at the end of World War II stumbling blocks were likely to exist in the form of

the trading groups (such as the Sterling Area) which had for long existed and whose cohesion and solidarity had been strengthened in the war. Moreover, the *ad hoc* requirements of immediate post-war reconstruction were to throw up new relationships which were soon to rival those established by paper planning in 1944. The power of the forces making for co-operation was great in 1944 and 1945 but it was widely recognised that this power was transient and that once it waned it might not be great enough to overcome old loyalties and new attractions.

All in all, the forces making for economic co-operation in the world at the end of World War II were strong and real. 'Taken at the flood' they might lead on to much that was useful and of permanent value. The obstacles, while they were considerable, were not insuperable. They tended to reflect the heterogeneity of the economic, social and political interests of nations, but in themselves they no more implied the inevitable failure of monetary co-operation than the diversity of peoples, races and colours in the United States of America or the Union of the Soviet Socialist Republics implies the failure of those nations as federal governmental systems.

Although this study must be limited solely to the economic aspects of international monetary co-operation we must recognise that the success or failure of any such experiments must depend as much upon political and non-economic factors as upon the economic merits of the schemes themselves. Mindful of this we must draw attention to three of the main non-economic aspects of the problem.¹

The first lies in the surrender of national sovereignty which must necessarily attend any international payments scheme or international anti-cyclical policy. This will occur whether members are required to submit to agreed rules of procedure or to the authority of an international organisation. In either case if the curtailment of national sovereignty is great it will be resisted, either by nations refusing to become parties to the arrangements, or worse, by their refusing to submit to external authority and acting in defiance of it the first time that national and international interests diverge.

¹ Cf. G. Schwarzenberger, *Power Politics* (Second Edition), London 1951, chap. 29, for an excellent discussion of the political aspects of functional international organisation.

It has been argued¹ that the international gold standard did not involve loss of national sovereignty by participant countries and this has been quoted as a point in its favour as compared with later attempts to establish world monetary authorities. This view is not in keeping with the facts. Membership of the gold standard did involve surrender of national sovereignty, partly to objective rules and partly to discretionary authority. The submission to objective rules was twofold: firstly loss of freedom as to the rate of exchange; and secondly loss of freedom as to domestic monetary policy. The submission to discretionary authority was to the London money market and the Bank of England who managed the gold supply.² During the nineteenth century this surrender of sovereignty was, for a variety of reasons, tolerable but when in the interwar period freedom for national monetary policies was sought the objective rules of the standard were openly flouted. It is not too much to say that refusal on the part of participant countries to accept the loss of sovereignty which the gold standard involved was a main cause of its ultimate breakdown.

There is no help for it: any international payments system must involve some loss of national sovereignty. Any system which we can envisage is likely to be a compromise between the extremes of a homogeneous world currency (which would of course mean complete surrender of national monetary control) and an unco-ordinated congeries of separate and unrelated monetary systems. The first of these is impracticable, the second intolerable. The problem lies in determining that degree of external authority to which member nations will submit, and which will allow the system to function smoothly. We shall later see, when considering the IMF, the difficulty of this task. In any international equilibrium system adjustment in balances of payments can only come in one of two ways: through an alteration in the external value of the currency; or through a movement in the level of domestic income, prices and costs. In order to make the system work some measure of control over one of these variables must be surrendered to external authority — either of rules or of institution. Yet on neither count will such surrender be lightly made. All of the large economies are pledged to maintain high and stable levels of employment.

¹ Cf. F. D. Graham, *Fundamentals of International Monetary Policy*, Princeton 1943; and Per Jacobsson of the BIS in the *Economist*, November 28th, 1942.

² Cf. Howard Ellis: 'Can National and International Monetary Policies be Reconciled?' *Amer. Econ. Review*, vol. 34, no. 1, part 2, supp., March 1944.

This precludes submission of the control over their national income levels. As for surrender of the national prerogative of deciding the exchange rate the continuity of thought can be summed up in two quotations: the first an extract from a speech made by a delegate to the Stresa Conference in 1932 — 'decisions touching upon monetary policy belong exclusively to the sovereignty of each country'; and the second a comment made by Prof. R. G. Hawtrey in 1945 — 'the limitation by the Bretton Woods plan of the freedom of a member to release its currency from fixed rates of exchange is a serious danger'.¹ Any practical attempt to place exchange rates under rigid international control would, in the present climate of opinion, be foredoomed to failure.

Coupled with this question of sovereignty is that of the sanctions which an international authority may use to enforce its will, and in the absence of which its authority can never be ensured. Such sanctions may be of varying type and stringency. They may, for example, consist merely of publicising and accurately reporting the action of a defaulting member, or they may consist of the withdrawal of rights, privileges or benefits over which the international authority has jurisdiction.² In this latter case the power of sanction becomes stronger the greater is the potential benefit to be derived from the organisation. Under both the Keynes and White Plans and under the IMF penalties were made so inconsiderable as to be of only symbolic importance; the sanctions applicable by the international organisation could only gain force as the latter grew in prestige and importance and its smile became something worth courting, its frown something to be avoided. In the present state of international opinion the setting up of an international body with real power over individual nations is unlikely. This lack of power must therefore be compensated by the authority having at its disposal benefits of such a character that their withdrawal in itself constitutes a penalty. Moreover, in the early days the authority would do well to avoid trials of strength with its members the outcome of which may well decide its fate.

A second non-economic factor lies in the political background to the monetary problems which we are considering and political conditions so influence economic events in the international sphere

¹ Cf. R. G. Hawtrey, *Bretton Woods for Better or Worse*, London 1946, p. 41.

² An example of the application of such a sanction was when the IMF denied France further access to the resources of the Fund following franc devaluation in 1948.

that it is necessary to make some sort of basic assumptions as to what they are likely to be. It would be easy and indeed tempting to explore this topic at length, but it would not be relevant. Two features may be singled out for notice which are germane to our problem — the first in the domestic, the second in the international sphere.

First, in the field of domestic politics we may be reasonably certain that the main concern of governments in their economic policy will be the maintenance of a high and stable level of employment. Numerous declarations in 1944 and 1945 attested to this and the history of the last ten years has demonstrated that not only do governments intend to honour their pledges but that any falling away will be speedily drawn to their attention by their electorates. This introduces a rigidity into the international economy inasmuch as one of the variables — domestic income — by whose movement adjustment in balances of payments was formerly achieved is now denied us. There has been since the war a marked unwillingness on the part of governments to pursue in the interests of external equilibrium any policy which reacts unfavourably upon domestic income and consumption levels.

Second, in the international sphere we must recognise that 'the unity of the West against the East is the ultimate political reality'.¹ This brings in its train a host of contingent factors both political and economic which, while they did not influence the 1944 experiments in international planning at their inception, must necessarily affect our judgement of their present and future fitness. As the rift between the democracies and the Communist countries has widened the international relations of the Western powers have changed imperceptibly in emphasis from economic reconstruction to defence. The mask has been dropped and loans or accommodating finance have been given by the United States to promote defence production or to cement alliances, while ends desirable in themselves, such as international coal and steel rationalisation schemes or even European integration itself have been harnessed to the build-up of forces against a feared Communist aggression.²

¹ Cf. Lionel Robbins, 'The International Economic Problem', *Lloyds Bank Review*, February 1953.

² The two most powerful international economic agencies, the IMF and IBRD are outside the range of Soviet influence since the Union of the Soviet Socialist Republics is not a member of either. They are therefore on 'one side only of the global chess board . . . and have been fitted into the wider functional pattern of the economic and social reconstruction of the non-Soviet world'. Cf.

Finally, we must recognise that the problem of monetary co-operation with which this study deals is but a part of the wider problem of international economic co-operation and that it cannot be solved in isolation. After all the money flows of which a payments system consists are but the result of flows of goods and services which reflect the international specialisation which is the motivating force of all international trade. If the structure of trade becomes stunted or malformed it is of little use replanning the payments system which is its reflection. Only if there is a broad advance along the whole front of economic co-operation can we tackle monetary problems with any confidence that our efforts will be successful.

It may be profitable in conclusion to relate the subject matter of what is to follow to the broad structure of international economics. The international trade problem is divisible into two more or less distinct sections: the problem of static equilibrium, in which we are concerned with the effect upon world productivity of free international specialisation; and the dynamic problems of the varying trade flows between given economic systems — some developing, some stagnating — over a period of time. Of this latter problem there are two aspects: the short-run foreign balance problem, in which are considered the movements of the foreign balance about a hypothetical equilibrium and the effect of foreign balance changes upon domestic national income; and the long-run problem of the pattern of world trade.

Our concern is with these two latter problems. This book deals with the strictly monetary aspects of international co-operation. More specifically it will consider three problems and the measures which the world has taken for their solution. These are: the problem of establishing and maintaining international payments equilibrium; the problem of long-term disequilibrium in the world payments system; and the problem of providing international measures for the control of cyclical fluctuations. These will be treated in Sections III, IV and V. Part II, which deals with the problem of international equilibrium is unavoidably theoretical for the writer has prefaced his discussion of the policy experiments by setting down as concisely and briefly as possible those parts of modern international economic analysis which seem germane to the practical problems later discussed and have value in examining the aims and working of

institutions.¹ The inclusion of such a body of theory is inevitable. In great part the efforts towards international monetary co-operation which have been made reflect this theory and can only be fully understood in relation to it. Moreover, formal economic analysis has a contribution to make in the formation of international economic policy. This lies in conditioning the minds of the makers of policy. Each problem as it arises is a special case and a subject for case study, theory providing the policy-maker with his knowledge of how the economy works and where his problem fits into the general structure.

¹ The writer has not attempted to introduce into this section any of the dynamic theory without which analysis of these problems must in the last resort be somewhat inadequate. To do so would have increased the length and difficulty of these chapters.

SECTION II

'We must speak by the card, or equivocation
will undo us.'

Hamlet

CHAPTER 2

THE BALANCE OF PAYMENTS AND ITS ADJUSTMENT

I

MUCH of this book is concerned with adjustments of deficits and surpluses in the balance of payments. It is therefore, a necessary preliminary that these terms should be defined — the more necessary in that they are often used loosely and without explanation, and have acquired unscientific trappings from which we must divest them.

The balance of payments of a country is 'a systematic record of all economic transactions during the period between residents of the reporting country and residents of other countries'.¹ In this general sense (and in an accounting sense) the balance of payments always balances since, as in all double entry accounts, total receipts must equal total payments if all transactions are included. Such formal balance, of course, applies only to the whole account, in which certain items — such as transfers of gold or currency reserves — may be balancing items. Total receipts and payments are equal only in the sense that there is equality in the receipts and payments of an individual who schedules as debits all his purchases, payments, loans and gifts, and as credits all income, borrowings and charity or credit received. Although equality of total debits and credits is basic to an understanding of the balance of payments, it has no independent meaning. It is rather from the isolating of certain balancing items within the schedule that useful inferences may be drawn.

When we turn to the individual items which make up the balance of payments we find that there are five groups of transactions. These are shown in Table I.

¹ Cf. IMF *Balance of Payments Manual* (Second Edition), January 1950, p. 1.

TABLE I
Pro Forma Balance of Payments

<i>Trade Items</i>	
<i>Credits</i>	<i>Debits</i>
1. Visible exports (i.e., export of goods)	6. Visible imports (i.e., import of goods)
2. Invisible exports (i.e., payments to the home country for services rendered to foreigners)	7. Invisible imports (i.e., payments by the home country for services rendered by foreigners)
<i>Transfer Items</i>	
3. Gold exports (i.e., physical export of the metal or reduction of the amount of gold held on earmark abroad)	8. Gold imports (i.e., physical import of the metal, or increase in the amount of gold held on earmark abroad)
4. Unrequited receipts (gifts and etc., received from foreigners)	9. Unrequited payments (gifts etc., paid to foreigners)
5. Capital receipts (i.e., loans from, capital repaid by, or assets sold to, foreign nationals)	10. Capital payments (i.e., loans to, capital repaid to, or assets purchased from, foreign nationals)
<hr/> Total receipts <hr/>	<hr/> Total payments <hr/>

As in normal accounting practice, the balance of payments is shown in terms of debit and credit entries. All international transactions which give rise to foreigners' money claims on the home country are debit transactions; all those giving rise to domestic money claims on foreigners are credit transactions. The full statement consists of two sections. The trade items include all payments for the import and export of goods and services in the given period. Items 1 and 6 show respectively the receipts from the sale of commodity exports to foreigners and amounts paid to foreigners in respect of commodity imports. The difference between these two items is referred to as the 'balance of merchandise trade' or the 'balance of visible trade'. Then there are the invisible trade items, 2 and 7, in which are grouped the inward and outward payments in respect of services — shipping freights, tourist expenditures, payments for financial and insurance services, and interest payments

in respect of outstanding loans. It will be observed that in all the trade items we are recording money payments from nationals of one country to those of another made in respect of flows of goods and services in the opposite direction. The difference between the debit and credit trade items we refer to as the 'balance of trade'. Or alternatively, we may say that the balance of trade is the difference between the value of goods and services sold to foreigners by residents of the home country and the value of goods and services purchased from foreigners by them.¹ In another sense it will be observed that the balance includes all transactions which give rise to or consume national income. This balance is, as we shall later see, not without significance, but from it alone no inference may be drawn as to whether the country concerned is or is not in monetary equilibrium with the rest of the world. In certain circumstances, as when a country is importing capital for long-term development, the balance of trade may for long periods be passive (i.e., debits may exceed credits); in others, as when a country wishes to transfer capital abroad either as gifts, loans or reparation payments, it must maintain an active balance. Only by relating the balance of trade to the transfer items can we obtain a complete picture of a country's international payments position.

Turning now to the transfer items we find that items 3 and 8 record movements of gold between countries. It might be argued that exports and imports of gold should be included as ordinary trade items under 1 and 6 just like any other commodity, but, since gold changes hands primarily for purposes of adjusting international indebtedness and is still the international monetary commodity, it is necessary to show them separately. Care must however be taken that there is not double counting, as would occur if gold movements were not precisely defined under one or other set of items.

In items 4 and 9 are grouped those receipts and payments which are not matched by simultaneous flows of goods and services in the other direction and which do not give rise to a claim or debt or take place in settlement of a claim or debt. Private transfers of funds, such as emigrants' remittances, governmental grants or reparations

¹ Here confusion as to terminology may arise. Some writers (e.g. S. Enke and V. Salera, *International Economics* (Second Edition), New York 1951, define the balance of trade as the difference between the value of merchandise exports and the value of merchandise imports making it the same as the balance of merchandise trade. Most writers however use the above definition. (Cf. J. E. Meade, *The Theory of International Economic Policy*, vol. 1, London 1951, chap. 1, p. 7.

payments are examples of such payments. Countries differ in their treatment of such items and it is usual to find them included in the current account (as with Britain and the United States) although clearly they are neither true current nor capital items but constitute a distinct category in themselves.

We are thus left with the capital receipts and payments (items 5 and 10) which differ widely in form, embracing such divergent transactions as an outstanding three months trade bill accepted abroad (or at home in favour of a foreign national) or an issue of long-term bonds in London by a foreign government. An obvious division may be made, however, between long term and short term capital movements, the former being capital transfers whereby nationals of one country acquire bonds, securities or tangible assets¹ in another with the purpose of earning a future income; the latter being funds which move relatively quickly from country to country in order to take advantage of differences in interest rates, for speculative purposes, or to serve as a balancing item should a nation overbuy or oversell on current account.²

We have now enumerated the various groups into which balance of payments transactions may be divided, but it is necessary to know more about the relationship of these groups to one another. We have distinguished two major categories in the balance of payments, the trade items (or income account) which give us the *balance of trade* and the transfer items, in respect of lending, borrowing and gold transfer,³ which give us the capital account and the *transfer balance*. Since in the whole balance of payments total receipts must always be equal to total payments, it follows that any positive trade balance must be offset by a negative transfer balance of like amount, and *vice versa*. Thus when a country buys in a given period more in import value than it pays for in export proceeds it must, over the same period be borrowing or receiving in unrequited transfers from other countries an exactly equal sum or else it must meet the excess by gold transfer. In like manner an export surplus must be matched by foreign lending, transfers, or the import of gold. But although this necessary offsetting equality of the *balance*

¹ It is of course a proviso that such assets must not be subsequently exported else they would be counted twice: once as a capital purchase, and once as an import into the country of the purchaser.

² Overbuying here refers to buying and selling not associated with the import or export of long-term capital.

³ We propose to treat gold as a transfer rather than as an ordinary commodity.

of trade and the *balance of transfer* is a self-evident fact, and a necessary basis for balance of payments analysis, it does not tell us how such equality is achieved. The major items in income account and transfer account are independently determined.¹ The fact that home investors are attracted to the purchase of a foreign issue of securities does not compel home traders to export more in order to ensure an increase in the trade balance; nor does an export surplus of itself drive home investors to seek outlets for overseas investment. The trade balance is determined by the demand and supply of exports and imports and thus in turn by the underlying complex of tastes, price reactions, costs, market conditions and incomes; while foreign borrowing and lending is (with given wealth and income structures) determined by interest rates and expectations. Wherein then may we derive meaning for the terms 'surplus' and 'deficit' in the balance of payments? If we include all items, balance (in the sense of equality) follows automatically, while for each category the balance (in the sense of a balancing item) is apparently motivated by different forces. What creates the equality in the total if the categories are not co-ordinated?

In order to answer this question it is perhaps best to examine an actual case; to assume that the balance of payments is in equilibrium, allow some change to take place which temporarily disturbs that equilibrium and to observe the result. Let us assume then that there is an increase of £100 mln in the home demand for foreign goods. In order that these additional imports may be paid for £100 mln worth of additional foreign currency must be found. Now clearly it would be possible for the monetary authority or the government to intervene and restore the situation in various ways, either by directly controlling imports so as to reduce their value by £100 mln; by the imposition of an import tariff; by fiscal policy calculated to reduce domestic incomes and therefore demand for imports; or by reducing the price of the domestic currency in terms of foreign currencies so that importers had to pay more to buy the same volume of imports; but we will assume that no such direct action is taken. What then are the reactions upon the balance of payments?

The importers will require £100 mln of additional foreign cur-

¹ Except in so far as a surplus of exports over imports may result in a rise in the surplus country's bank deposits held in the receiving country, that is, in a capital outflow from the surplus country.

rency. This they may obtain in several ways. If the amount of additional currency required is small it can probably be obtained from exchange dealers who will temporarily be prepared to reduce their holdings of foreign currencies and hold balances of the domestic currency, selling dollars, lire, and francs to customers in exchange for pounds. This is equivalent to a short-term loan of the foreign currency and so part of our £100 mln increase in item 6 (see Table 1) is offset by an increase in item 5. But if dealers cannot (as is likely) advance so much as £100 mln, what of the residue? Importers may then have recourse to the central monetary authority demanding either gold or foreign currencies in exchange for the domestic currency. Assuming that exchange markets are free and that the monetary authority holds gold and currency reserves the additional demands will be met by the monetary authority and payment made to foreign exporters either in gold or in the foreign currency — the increase in item 6 being offset by an increase in item 3. The size and duration of the additional demand which can be borne by the monetary authority in this way depends of course on the size of the reserves at its disposal. If these are large a considerable and sustained adverse trade balance may be financed, but if they are small the monetary authority may be quickly driven to cease gold payments and to resort to more direct action. It should be noted, however, that whether the overspending is met by the running down of dealers' foreign balances or by drawing on central reserves these adjustments are unplanned and automatic arising because of the original increase in the demand for foreign currencies. Yet another means by which the additional demands of importers for foreign currencies may be met occurs when a foreign country grants a credit or gift of a stipulated amount of its currency to the debtor country. This means that in Table I the original increase in item 6 is offset by an increase in item 4 or 5. Here, however, the offsetting transfer is planned and is the result of conscious discretionary action. Moreover, providing the credit is large enough, it enables the adverse trade balance to continue for some time. Such a means of dealing with the adverse trade balance depends upon the goodwill of the surplus country and will only be used if that country believes there are good reasons for not using more direct methods such as deflation in the deficit country or a change in the par value of its currency.

Such offsetting changes in the balance of payments as those we

have described, occurring only because some original change has left a gap to be filled, are referred to as 'accommodating' payments¹ and must be distinguished from 'autonomous' payments which occur independently of other items. Moreover, the accommodating payments are of two types: automatic, as in the first two cases above, or planned as in the case of a gift or loan made at the discretion of a creditor country. Thus we must include as autonomous items, commercial imports and exports, unrequited payments such as emigrants' allowances, legacies and private gifts, reparations payments, and all foreign capital investment undertaken for profit by private enterprise; and as accommodating items, gold or currency transfers by central monetary authorities, short-term balance adjustments, and loans (such as the Anglo-American Loan of 1945) or gifts (such as transfers made under the European Recovery Programme).

We are now, with the aid of these distinctions, in a position to define, with reasonable accuracy, the nature of a 'deficit' or 'surplus' in the balance of payments. A deficit is measured by the actual amount of accommodating finance required over a given period of time (as credits); a surplus as the amount of accommodating finance which must be disbursed (as debits). Moreover, a deficit may be 'actual' or 'potential'; actual if accommodating payments are taking place; potential if the account is being given the spurious appearance of balance, by the government intervening directly to control imports or pursuing some other policy designed to conceal imbalance. A potential deficit is therefore measurable by the amount of accommodation which would be required to be provided in a given period to avoid the use of such controls over the demand for foreign currency. Probably the most common example of 'potential' deficit in recent years has been where countries have maintained levels of national income bordering upon inflation and suppressed the resulting high demand for imports by means of exchange control and direct import restrictions.²

¹ Here we make use of Prof. Meade's terminology. This section leans heavily on Prof. Meade's excellent discussion of the balance of payments in vol. 1, chap. 1 of his *International Economic Policy* and readers requiring amplification of the above points should refer to this chapter.

² Other examples of 'potential' disequilibrium which have been cited are those of Britain in the years 1925-31 when the British balance of payments was kept in equilibrium only at the cost of depressed conditions at home compared with conditions in the outside world (cf. Ragnar Nurkse, 'Conditions of International Monetary Equilibrium', *Essays in International Finance*, no. 4 (Princeton 1945), reprinted in *Readings in the Theory of International Trade*, p. 10) and of Germany in the years after 1934 'when Germany's external accounts were

Clearly in the above definition of deficits and surpluses we have a useful tool with which to work in balance of payments analysis. It may be further strengthened by introducing the time element. If time be ignored there is no distinction between a country whose trade deficit is offset by long-term foreign borrowing¹ and whose foreign account is therefore in balance; and a country whose trade deficit is at the moment fortuitously offset by a simultaneous inflow of short-term funds perhaps drawn from abroad by interest rate margins or seeking asylum from a less secure financial centre.² In the latter case, however, the circumstances which attracted the capital are temporary and the departure of the short-term funds will reveal a deficit in the external accounts of the country in question. For a complete picture of a country's balance of payments one must view the items qualitatively as well as quantitatively and with reference to their variations over a period long enough to eliminate random and seasonal fluctuations.

Lastly, a distinction must be made between disequilibrium in a country's balance of payments with the rest of the world and disequilibrium in its balance with a single country. In a world in which currencies are freely convertible overall balance is in itself sufficient inasmuch as deficits with countries A and B can be set off against surpluses with countries C and D. In a world where currencies are inconvertible, however, imbalance with a given country will result in shortage of that country's currency, and the country suffering the imbalance may be driven to direct measures, such as import or exchange control, in order to meet the deficit. This distinction has become of great importance since 1945, since when the large deficits of European and other countries with the United States have created a great, and, at times, overwhelming demand for dollar currency. This has resulted in a number of currencies (notably the pound) remaining inconvertible and only strict exchange control and import restriction has enabled the huge dollar deficit to exist within balances of payments which, in an overall sense, have often been in equilibrium. Overall balance and convertible currencies can of course only exist in a multilateral system where some countries have surpluses to set off against the deficits

balanced only by means of additional import restrictions'. Cf. R. Triffin, *National Central Banking and the International Economy, International Monetary Policies, Postwar Economic Studies*, no. 7 (Washington, September 1947), p. 76.

¹ As in the case of a developing new country, e.g. Canada from 1900 to 1913.

² As in the case of London in 1929, 1930, and early 1931.

of others,¹ and this has not been the case since the war. The result has been the division of the world into regional clearing groups within which currencies are convertible and between which exchange control forms a barrier. Thus the over-all balance of payments no longer enjoys the supreme significance which it did under freely convertible currencies, but must be analysed on a regional

TABLE II
United Kingdom General Balance of Payments 1952
(£ mln)

A. CURRENT ACCOUNT

<i>Credits</i>				<i>Debits</i>			
Exports and re-exports	-	2,825		Imports	-	-	2,944
Shipping	-	-	401	Shipping	-	-	294
Interest, profits and				Interest, profits and			
dividends	-	-	287	dividends	-	-	188
Travel	-	-	80	Travel	-	-	83
Government settlements				Migrants' funds, legacies,			
etc.	-	-	45	private gifts (net)	-	-	15
Other (net)	-	-	233	Government outlays			
				abroad	-	-	217
			3,871	Balance of current trans-			3,741
				actions	-	-	130
				Add net Defence Aid from			
				U.S.	-	-	121
				Balance of current trans-			
				actions and U.S. De-			
				fence Aid	-	-	+251

B. INVESTMENT AND FINANCING ACCOUNT

Overseas investment	-	-	78
Sterling liabilities, decrease	-	348	- 426
Drawings on gold and			
dollar reserves	-	-	+175

Total of Investment and
Financing account - - 251

¹ As for example during the interwar period when the United Kingdom's passive dollar balance with the United States, was financed by its active balance with Empire countries, who by sale of primary products to the United States had an active dollar balance. In 1929 (a year which approximates to equilibrium) Britain earned a transfer of £265 mln from Empire countries, using this transfer to finance a passive trade balance with the United States and certain West European countries.

basis before the true extent of disequilibrium can be assessed.

Our discussion has this far been somewhat theoretical. It may be useful at this stage to apply the principles which we have evolved to the United Kingdom Balance of Payments in 1952. In Table II this balance of payments is summarised.¹

The purpose of a balance of payments is to present a summary of a country's economic transactions with other countries. From an accounting standpoint it is desirable that the statement should in its presentation demonstrate those principles which we have already described, while at the same time presenting us with accurate and meaningful classifications which may be integrated into the general structure of national income accounting, from which inferences may be drawn and on which policy judgements may be based. There are many forms of presentation of the balance of payments and each of the great economies has its own usages.² The British official version in Table II is fairly typical.

In Table II the division between trade items and transfer items which we had in Table I emerges as the Current Account and the Investment and Financing Account. In the former are grouped all the trade items, visible and invisible, together with three other items which are of a current rather than a capital nature — namely Government Settlements which consist of settlements in respect of war-time government transactions, disposal of stores and miscellaneous government outlays current in the period; the item Other (net) in which is included all current transactions not included under other heads, the most important being the foreign transactions of

¹ Cf. *United Kingdom Balance of Payments 1946-1955*, Cmd 9585 of 1955. The terminology used above is that of the White Paper. Its application to the categories already distinguished will be explained where necessary.

² A major balance of payments problem is that of standardisation. The earlier estimates of the balance were made mainly by individuals requiring the data for their own use — as in the protection/free trade controversy. The first official estimate was made by the Board of Trade for the year 1907 and it was not until the inter-war period that official estimates were published regularly. The greatest fillip to balance of payments computation came from two sources: the use of the concept in national income accounting and the growth of government control over trade which enabled the data to be collected. Into the diversity of uncollated information the League of Nations sought to introduce system and uniformity through a standardised classification and this work was continued by the IMF to whom all member states are obliged to furnish data. The Fund's *Balance of Payments Manual* and *Balance of Payments Year-book* provide a standard form for the balance and data for members' balances in this form. For a critical commentary of the IMF standard classification cf. 'The Balance of Payments: A Tool of Economic Analysis', Donald G. Badger, *IMF Staff Papers*, vol. II, no. 1.

oil companies, and payments for insurance, civil aviation, royalties, commissions, banking and other services; and the item Migrants' Funds, etc., which, although an unrequited transfer, is not a capital transaction in as much as no foreign assets are acquired by these payments. From the Current Account we can obtain the balance of merchandise trade ($-\pounds 119$ mln), the balance of invisible trade ($+\pounds 249$ mln), and the balance of trade which now appears as 'the balance of current transactions' ($+\pounds 130$ mln). From this we know that in 1952 Britons were earning abroad $\pounds 130$ mln more than they were spending on current needs. This favourable balance on current account was, however, augmented by $\pounds 121$ mln received from the United States under the Mutual Defence Assistance Agreement in support of the British defence programme and, as this aid is of a special character being determined by strategic considerations and not being intended primarily for balance of payments adjustment, it is excluded from both the Current and the Investment and Financing Accounts. We may then say that from current foreign earnings plus aid the United Kingdom in 1952 received $\pounds 251$ mln. All of the items thus far are autonomous, representing transactions undertaken for reasons other than balance adjustment.

When we turn to the Investment and Financing Account the summary tells us that this $\pounds 251$ mln was more than offset by $\pounds 426$ mln of overseas capital payments (partly repayment of outstanding loans, partly private investment, and partly reduction of sterling liabilities to Sterling Area and foreign countries), leaving $\pounds 175$ mln to be covered by an accommodating gold transfer. It is impossible to estimate what portion of this $\pounds 426$ mln of capital payments consists of accommodating transfers and what portion of autonomous. For this a very minute analysis of the statistical items would be required.¹ Nevertheless, the whole statement shows clearly the

¹ The IMF in its *Balance of Payments Yearbooks* presents balance of payments data for member countries in such a form as to isolate official compensatory financing, private compensatory financing and autonomous financing. In the *Yearbook* for 1949 there is a lengthy introduction which deals with the problem of the classification of international transactions in order to distinguish between 'induced' and 'autonomous' capital movements and defining (at considerable length) the concept of 'compensatory official financing'. For present purposes we can take this term to mean all payments which are intended by monetary authorities to close a balance of payments deficit or surplus. All who are interested in the more recondite aspects of balance of payments accounting should consult the *Yearbook* for 1949. Cf. also Fritz Machlup's 'Three Concepts of the Balance of Payments and the So-Called Dollar Shortage', *Economic Journal*, March 1950 for criticism of the Fund's classification of certain transactions.

reciprocal nature of the two sections, the independent motivation of the trade and capital items, and the role of the final accommodating gold transfer. In assessing the external position of the United Kingdom in 1952 we are in a position to see that, in spite of a substantial favourable balance of trade, Britain's overseas commitments for debt retirement and capital outlay were too great to be met without a deficit,—albeit a smaller one than in preceding years.¹

When the time-focus is widened it can be seen that it was only in the second part of 1952 that the serious deficit of the previous year yielded to treatment, and in fact the £232 mln of accommodating transfers of gold from the reserves in the first six months were replaced by an inflow of £57 mln in the second half of the year, thus giving us the net figure for accommodation of £175 mln. Although balance of payments figures are prepared for calendar years, it is well to consider their movement over a much longer period in order to appreciate the true nature of the forces at work. The trade items are subject to certain long term influences, as is also, although more indirectly, the case with overseas investment. A balance of payments can scarcely, therefore, be spoken of as being in equilibrium at any given moment but only over such a period as will eliminate these fluctuations. The reserves held by central monetary authorities should therefore be large enough to provide accommodating transfers to meet such fluctuations. If over a period long enough to iron out day-to-day and seasonal fluctuations² there is no net change in a country's holdings of gold and foreign exchange reserves then the balance of payments may be said to be in equilibrium. Indeed it might appear from the experience of the post-war years that in a world of full employment, where the great economies border on a condition of inflation, sudden and violent swings in the balance of payments are inevitable and a year's figures may be compounded of a series of sharp movements whose violence and significance do not register significantly in yearly totals because of compensating movements.³ In order to get a true

¹ In the second half of 1951 the loss of gold and dollars was £550 mln.

² It is of course arguable that cyclical fluctuations should be considered. Clearly however if we are thinking of balance of payments analysis for current policy such a period as 8–10 years is unrealistic and we must be content with yearly statements.

³ Several examples spring to mind: the swift rush into deficit of the British balance of payments in the second quarter of 1951 under the influence of the inflation attendant upon rearmament; the rapid deterioration of European balances with the United States in the spring of 1949 as a result of the inventory recession in that country.

picture of a country's balance of payments condition a close scrutiny of several year's figures is called for.

From our account of the balance of payments the reader must carry away one clear idea. It is this. The balance of payments represents an *ex post* equality of the demand for and supply of the country's currency — an equality ensured by double-entry book-keeping. But *ex ante* there was no such equality of demand and supply for these were the result of dispersed and divergent desires and motives. The means of reconciliation of the *ex ante* divergence and the *ex post* equality lies at the heart of international monetary policy. There are four ways by which such reconciliation takes place. They are:

1. The divergence between demand for and supply of the country's currency may cause its price to alter, that is the exchange rate will change.
2. Prices and income in the country may alter and so bring shifts of demand for imports and exports which will tend towards balance.
3. The excess of demand for the country's currency over supply of it may be met by drawings upon reserves held by the countries who experience the scarcity, or alternatively by the voluntary loan or gift of its currency by the surplus country; and
4. Direct controls over foreign currency transactions may seek to establish equality of supply and demand.

These four methods of achieving *ex post* equality in foreign receipts and payments exhaust the possibilities of adjustment. Much of this book will be spent in discussing them.

II

Instability in a country's balance of payments may arise from many causes, but three types of disturbance seem to be discernible. Firstly, a deficit may spring from unavoidable and unforeseeable causes, such as the failure of a crop harvest on whose export the country depends, a change in consumer tastes, technological innovation, a sudden worsening of the terms of trade as a result of rising import prices,¹ or political upheaval abroad resulting in loss of export markets or of income from foreign investments.² Such sources of instability are inevitable and any adjustment process, if

¹ As that which Britain suffered in 1950 as primary commodity prices soared after the outbreak of war in Korea.

² As the loss of income attendant upon the surrender of oil refineries at Abadan in 1951.

it is to be adequate, should be capable of dealing with them. Secondly, instability of the foreign balance may be caused by changes in the economic situation, either at home or abroad, which could be avoided by government action. For example, inflationary or deflationary movements at home may create a deficit or surplus through their income and price effects, while similar movements in foreign countries may react upon the home country through similar variations abroad. Such sources of instability are, however, avoidable if governments adopt policies to stabilise prices and incomes each in their own countries, and react to changes when they occur by the application of counter measures of fiscal or monetary policy. It is not in itself sufficient, however, that such policies should be unilateral. Unless they are in some way co-ordinated differential income and price changes may still serve to create instability in balances of payments.¹ And thirdly, instability of the foreign balance may occur as a result of deliberate policies pursued by governments, as when a country imposes an import tariff, an export subsidy or a direct restriction by quota or embargo upon imports or exports; or as a result of government trading or exchange control policy. Such changes inevitably result in retaliatory action. Since such action is taken for the purpose of reaping unilateral advantage it is inevitable that those at whose expense the advantage is reaped should act in their own defence, and governmental interference with international trade in this case tends to become general.

Any discussion of the adjustment process must seek to lay bare the relationship between national economies, each with its own currency unit, price-system and set of price/cost relationships. The usual method of procedure is that of starting with a number of countries in a state of equilibrium, assuming some autonomous disturbance, and observing the process by which equilibrium is restored. The condition of international equilibrium — i.e., a condition in which all balances of payments are in balance in the long run — is a condition which will rarely, if ever, be achieved in practice, but it is the condition towards which the system is always tending, and it serves as a norm by reference to which we may study the directions of change of the system. It is of course the nature and motivation of such changes which are important.

¹ For example, although all countries may be pursuing full employment policies, those whose policies are more inflationary will develop deficits on foreign account with those whose policies are less inflationary.

Economic theory has furnished us with two explanations of the adjustment process: the classical approach which conceives adjustment as operating through changes in the price-levels of commodities; and the comparatively recent income approach which regards equilibrium as being restored by relative changes in the national incomes of individual countries. Each approach springs from the general body of economic theory current at the period of its inception; the classical approach reflecting the Ricardian system with its emphasis on price changes, the Quantity Theory of Money and the theory of comparative advantage; the income approach from the Keynesian theory of income determination with its emphasis on demand determined by income rather than by price. Moreover, each approach to some extent dictates a different emphasis for policy: the classical approach underlying the use of monetary policy for price adjustment; the income approach reflecting the modern belief in the use of fiscal policy for income adjustment. The synthesis of these two views is by no means complete. The classical approach, although it has yielded ground to newer ideas, still contains much that is of value and of significance for policy. It has been supplemented rather than supplanted by the income approach. It is true that in the adjustment process price and income forces work in the same direction, but it seems now to be established that price changes are subsidiary and follow only upon changes of income. 'In so far as they occur at all they are essentially a by-product of the changes in the volume of employment and productive activity.'¹

The classical approach to the problem of balance of payments adjustment as developed from David Hume to John Stuart Mill is an application to international trade of the well-known concept of static equilibrium. The movement of goods is assumed to be the result of relative price-levels and is explained in terms of the Theory of Comparative Costs. The upward or downward movement of an individual country's price-level changes the direction and volume in which goods flow and therefore, since the classicists assumed away the existence of international capital transactions, alters the balance of payments of the country concerned. It follows that a disequilibrium, being the result of a change in relative price-levels, can be adjusted by a further change. In the last resort one might

¹ Cf. Ragnar Nurkse, 'Domestic and International Equilibrium', in *The New Economics*, edited by Seymour Harris, London 1948, chap. 21, p. 269.

then describe a country's external equilibrium as a unique position reflecting its own price/cost relationship relative to that of the rest of the countries in the world system.

In the determination of national price-levels the Quantity Theory of Money, which since the time of Hume had dominated ideas on general price determination, was basic. According to Ricardo, for equilibrium to obtain, the world monetary supply must be distributed among nations in the same ratio as their national products, such a monetary distribution ensuring price ratios appropriate to general equilibrium.¹ Any increase in a nation's national product would result in a favourable trade balance, an inflow of gold and hence a redistribution of the monetary supply in such a way as to restore a pattern of prices appropriate to equilibrium.

There were two ways in which international and national prices might be equalised: either national levels of money prices and costs might be adjusted upward or downward in order to conform to the international level, or alternatively the rates at which national currency units exchanged one with another might alter periodically so that the appropriate ratios of national price levels to one another might be maintained. In other words, with a gold standard in operation differences between foreign receipts and payments would be counterbalanced by such gold flows as would, by enlarging or depleting the national monetary stock, produce appropriate price changes to alter demand for the imports and exports of the country concerned and thus correct the balance; while, in the absence of a gold standard, fluctuating rates of exchange would adjust themselves to a natural level at which supply of and demand for foreign currencies would balance. In brief, the classical theory of adjustment 'is one of the equalisation of prices internationally, variations in exchange rates and adjustments of prices as a result of gold movements being alternative means of establishing the normal relation of equality'.²

Underlying the classical account of the adjustment process was the assumption of the validity of the Quantity Theory of Money and the efficiency of monetary weapons (credit control and interest rate changes) as determinants of the level of prices. The chain of reason-

¹ Clearly we must assume a fixed world monetary supply — an assumption not unjustifiable in Ricardo's day since he clearly thought of money in terms of gold supply. Cf. *Principles of Political Economy and Taxation* (Everyman Edition), pp. 90-3.

² Cf. Barrett Whale. *International Trade*, London 1932, p. 48.

ing required that, with an inflow of gold into a country's central bank, the strategic reserve ratios would rise making credit expansion both possible and desirable, and that, with this, prices would rise so as to curtail foreign demand for the country's exports and stimulate domestic demand for imports whose prices would have fallen relatively to those of home produced goods. Moreover, it was assumed that the processes of inflating and deflating the system in response to gold inflows and outflows were without friction and that there were no adverse effects upon output and employment. The sole effect of monetary reactions would be upon price. The classical assumption of a fully employed economy remained unimpaired. But over and above all this the classical adjustment process, whether engineered by gold standard reactions or by exchange rate variations, depended upon quick and considerable reactions of both demand and supply to price changes. Under both methods of adjustment envisaged by the classical theory, adequate response of demand and supply to price changes of internationally traded goods was a *sine qua non* of a smoothly functioning mechanism.

The classical theory remained for a century the standard explanation of international equilibrium adjustment. It formed the basis of the theory of the gold standard and of free exchanges and the banking and monetary systems, together with policy decisions, were criticised in relation to its postulates. It endured so long, partly because, in the smooth-running tides of the nineteenth century, there seemed little cause to question either the theory or the automatic procedures which it dictated; partly because no alternative theory appeared to challenge its supremacy. Not until economists emancipated themselves from the myopia of a world seen only in terms of supply and demand, and until the international complexities of the interwar years demanded more powerful tools of analysis was the classical approach called in question.¹

¹ Scepticism dates from the early nineteen-twenties. A number of empirical investigations (notably those of J. H. Williams, Jacob Viner, F. W. Taussig and Harry D. White) of balance adjustment were made during this period and although they appeared to substantiate the classical thesis the speed of reaction of the variables involved caused some speculation as to whether some hitherto unsuspected force might not be at work. This was certainly the feeling of Taussig about the time when he published his *International Trade* in 1927. Studies of demand elasticities during the 'thirties seemed to indicate that demand was much less sensitive to price changes than had been thought and this served to deepen the scepticism. For a good brief account of the decline of the classical theory of international equilibrium see Lloyd Metzler's excellent essay in chap. 6 of *A Survey of Contemporary Economics*, Philadelphia 1948.

With the impact of Keynesian ideas upon monetary theory the view of the adjustment process was fundamentally altered and a new approach, stemming from the theory of income determination contained in Keynes's *General Theory of Employment Interest and Money* (1936), replaced (although it did not disprove) the older classical theory. This applied to the process of balance of payments adjustment the powerful analytic tool of the national income multiplier and changed the medium of adjustment from the field of interacting price levels to that of differential income changes.¹ Although the income approach to international trade was not completely new it undoubtedly provided a more comprehensive picture of international monetary relations and gave not only an explanation of the adjustment process but also a picture of how fluctuations in economic activity are transmitted from one country to another. Thus was effected a marriage of international trade and business cycle theory from which much might be expected. Moreover, the scope of the income analysis was broader since it embodied explanations of two separate, but related processes: the 'adjustment process' whereby a balance of payments is adjusted by changes in the relative income levels of the countries concerned and the 'transmission process' which shows how variations in the national income of one country may, through its balance of payments, cause variations in the incomes of other countries. Both have far-reaching implications for policy and for international monetary co-operation.

We shall deal in a later chapter with certain more detailed aspects of the price adjustment process, which is, as the basis of the gold standard and of freely varying exchange rates, reasonably familiar.

¹ Although the new theory was Keynesian in substance Keynes played no direct role in forming it. Ohlin, writing on the German transfer problem in 1928, had emphasised the part which shifts in demand would play in adjusting the balance of payments and the theme was developed in his *Interregional and International Trade* (1933). In the controversy between Ohlin and Keynes on the transfer problem Keynes argued on conventional classical lines that the transfer of German reparations could only be effected through a reduction of German prices relative to the world level. In the *Treatise on Money* (1930) it appeared as though Keynes had had second thoughts. Although the *General Theory* (1936) does not deal with international trade problems it can be assumed that Keynes was well aware of the implications of his employment analysis for that branch of economics. The early steps in formulating a new approach to the adjustment process were taken by Mrs. Robinson (cf. *Essays in the Theory of Employment*, (Second Edition), Oxford 1947, section entitled 'The Foreign Exchanges') and R. F. Harrod (cf. *International Economics*, Cambridge 1933, chap. 5). For a finished statement of the theory see Fritz Machlup, *Foreign Trade and the National Income Multiplier*, Philadelphia 1943.

It is necessary, however, to dwell somewhat longer on the income adjustment process which is, perhaps, less familiar in its theoretical background although it commends itself quickly to both commonsense and experience.

Let us assume initially a closed economy with some idle resources and constant prices. In such an economy the level of national income (Y) is determined by the level of aggregate demand ($Y = C + I$) which is made up of demand for consumption goods (C) plus the demand for investment goods (I). The amount received in payment for total output is passed on to the factors of production as factor cost. It is the total of these factor costs (or factor incomes) which makes up the national income (Y).¹ Any autonomous increase in demand will cause income to increase, not only by the amount of the initial increase in outlay but by a multiple of it — this multiplier effect being the result of the secondary and tertiary effects of the initial increments of demand. Let us suppose, for example, that there is an autonomous increase in I , that is that capital goods costing ΔI are added to the country's capital stock. This increment of I will result in an immediate increase in the incomes of factors in the capital goods industries, part of which increment of income will be spent and part saved. If we call the part which is

spent $\frac{\Delta C}{\Delta Y}$ the 'marginal propensity to consume' and the part saved

$\frac{\Delta S}{\Delta Y}$ the 'marginal propensity to save', it is clear that $\frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y} = 1$.

Once the initial increment of demand (ΔI) has occurred it generates an increase in consumption of $\frac{\Delta C}{\Delta Y} \cdot \Delta I$ by the initial recipients of the increment of income, and this amount is thus passed on to a new group of income receivers. These in turn spend $\frac{\Delta C}{\Delta Y}$ of their additional incomes and so $\left(\frac{\Delta C}{\Delta Y}\right)^2 \cdot \Delta I$ is passed on to yet another group. If we assume that, at each round of spending, the marginal

¹ The following points as to the definition of these items should be noted. Consumption (C) and investment (I) are net of all intermediate goods to avoid double counting. Investment is net of depreciation while saving (S) is net of depreciation allowances.

propensity to consume $\frac{\Delta C}{\Delta Y}$ is constant¹ then at the n th round the increase in consumption will be $\left(\frac{\Delta C}{\Delta Y}\right)^n \cdot \Delta I$ and the total increase in income ΔY for the n rounds will be the sum of this geometric progression to n terms.² This (by applying the simple formula for the sum of a geometric progression to n terms)³ reduces (in the limit as n becomes very large) to

$$\Delta Y = \Delta I \left(\frac{1}{1 - \frac{\Delta C}{\Delta Y}} \right)$$

or $\Delta Y = k \cdot \Delta I$ where k the multiplier is equal to

$$\frac{1}{1 - \frac{\Delta C}{\Delta Y}}$$

It may be useful to see the same process in numerical terms. If the primary income receivers spend $\frac{3}{4}$ of the increase of their incomes an amount equal to $\frac{3}{4}(\Delta I)$ is passed on to a further group of income recipients. These in turn spend $\frac{3}{4}$ of their additional income and thus $(\frac{3}{4})^2 \cdot \Delta I$ is passed on to yet another group. If at each round of spending $\frac{3}{4}$ of the new income is spent and $\frac{1}{4}$ saved

¹ It is not unreasonable to assume that spending/saving patterns are reasonably uniform and that the proportion of an increment of income which is consumed is relatively constant for small changes in income.

² n is here assumed to be very large. In practice it will be so, for many rounds of expenditure will be required for the process to work itself out fully.

³ The formula for the sum of a geometric progression to n terms is $S = \frac{a(r^n - 1)}{r - 1}$ where S is the sum required, a the first term, r the common ratio, and n the number of terms. Applying this formula, with ΔI as the first term and $\frac{\Delta C}{\Delta Y}$ as the common ratio, the equation for S becomes

$$S = \frac{\Delta I \left[\left(\frac{\Delta C}{\Delta Y} \right)^n - 1 \right]}{\frac{\Delta C}{\Delta Y} - 1}$$

and, since we are interested economically in the sum S as n approaches ∞ and as n approximates to ∞ , so $\left(\frac{\Delta C}{\Delta Y}\right)^n$ may be discarded leaving

$$S = \Delta I \left(\frac{1}{1 - \frac{\Delta C}{\Delta Y}} \right)$$

then at the n th round the increase in income will be $(\frac{3}{4})^n \cdot \Delta I$, and the total increase in income for the n rounds will be $4 \cdot \Delta I$, or the original increase in demand multiplied by four. This multiplier k is determined by how much of the additional income is passed on in further consumption at each round of expenditure.

We can now see that $\Delta Y = k \cdot \Delta I$ where

$$k = \frac{1}{1 - \frac{\Delta C}{\Delta Y}} = \frac{1}{\frac{\Delta S}{\Delta Y}}$$

or, in verbal terms, that an increase in investment will increase income by k times the increment of investment, where k is the reciprocal of the marginal propensity to save. In the numerical example an increase in investment of £100 mln would, with a marginal propensity to consume of $\frac{3}{4}$ increase income by £400 mln, the multiplier being 4. The greater the marginal propensity to consume (or the lower the marginal propensity to save) the greater will be the value of the multiplier.

In this process of income circulation the marginal propensity to save is best regarded as a 'leakage' since at each stage of the circulation money saved is withdrawn from the income stream. Were it not for this leakage the original increment of investment would lead to a limitless increase in income. The multiplier may then be spoken of as the reciprocal of the value for the leakage. Moreover, the ultimate total of money saved out of all the rounds of expenditure will, when the process has worked itself out, be equal to the original increment of investment. This can best be seen by setting out the circulation of income over a series of periods.

In Table III (a) the effect upon income of a single autonomous increase in investment is shown.¹ With an additional outlay of £100 mln and a marginal propensity to consume of $\frac{3}{4}$ the increment of income falls progressively at each period until, after a sufficiently large number of periods, the increase ceases to be significant. At the end of n periods the total increase in income

¹ For the sake of simplicity we shall adhere throughout to the Keynesian definition of saving, namely that $S_t = Y_t - C_t$. The time element in multiplier theory is of great importance and readers wishing to proceed to the study of intertemporal income relationships would do well to consult Fritz Machlup's 'Period Analysis and the Multiplier Theory', *Quarterly Journal of Economics*, November, 1939.

TABLE III

Process of Income Circulation
(£ mln)

(a) <i>With single injection of £100 mln in period 1</i>		(b) <i>With successive injections of £100 mln</i>	
<i>Period</i>	<i>Extra Income ΔY</i>	<i>Extra Income ΔY</i>	
1	100	100	
2	75	175	
3	56.25	231.25	
4	42.19	273.44	
5	31.64	305.07	
6	23.73	328.81	
7	17.80	346.61	
8	13.35	359.96	
9	10.01	369.97	
10	7.51	377.48	
11	5.63	383.11	
12	4.22	387.33	
13	3.16	390.5	
14	2.37	392.87	
15	1.78	394.65	
16	1.33	395.99	
17	1.00	396.99	
18	.75	397.74	
19	.56	398.3	
20	.42	398.72	
—	—	—	
—	—	—	
<i>n</i>	—	400	
		<hr/>	
		400	
After <i>n</i> periods: $\Delta C = 300$			
$\Delta S = 100$			
$\Delta Y = 400$			
$k = 4$			

will be £400 mln while the total saving is £100 mln and is equal to the original increment of investment.

The second part of Table III traces the behaviour of income when the increment of £100 mln of investment is continued in each period. It will now be seen that the rise in income is progressive and rapid, the total approaching asymptotically a value which is k times the constant level of investment and the leakage rising until it is ultimately equal to the autonomous injections. This *ex post* equality of injection and leakage is fundamental. Here it is the familiar equality of saving and investment. When we relax the assumption of a closed economy, we shall see that it applies even when there are several injections and several leakages.

We may now remove the assumption of a closed economy¹ and, recognising the fact that a country makes payments to and receives payments from the rest of the world, extend the multiplier analysis. This extension may take two main forms. We may deal with the case of an increment to domestic investment and trace the effect of this upon national income and upon the export/import relationship. In other words we may consider the operation of the domestic multiplier in an open system. Or alternatively, we may think in terms of an autonomous increase in a country's exports leading to changes in national income and the balance of payments. We will make the second approach.

No alteration of principle is called for in the argument as it was applied to the closed economy. The basic relation of income and aggregate demand is still denoted by the equation $Y = C + I$. But I must now be divided into home investment (I_a) and foreign investment (I_f), so that $I = I_a + I_f$ where I_a represents the net addition to the country's capital stock, and where I_f , the amount of foreign investment, is equal to the change (positive or negative) in the country's total foreign investment as a result of lending and borrowing. Such foreign investment is, however, equal to the difference between exports and imports of goods and services, in other words to the balance of trade. Thus, if x be the value of all exports of goods and services and m the value of all imports then the basic income equation for an open economy becomes $Y = C + I_a + (x - m)$. Thus it is apparent that a favourable balance of trade is, like domestic investment, income creating for the country concerned and is subject to the same multiplier effect as an increase in domestic

¹ Constant prices and the existence of some idle resources are still assumed.

investment. An increased favourable balance of trade will cause income in the country concerned to rise by a multiplied amount.

We can now restate the above income-multiplier relationship in general terms:

$$\text{Increase in money income} = \frac{\text{Autonomous Injection}}{\text{Leakage}} \quad \text{where an}$$

autonomous injection may be any autonomous increase in demand and the multiplier is the reciprocal of the leakage.

Let us extend this formula to several distinct cases which may arise under international trade.

Case I — Domestic Saving

First, assume that there is an autonomous¹ increase (E) in the exports of the country (X) to the rest of the world (W). The sellers of exports in X will find their incomes enhanced by E_x . They will use part of this increased income for further expenditure and save part, the part saved being (S_x).² The increase in X 's income ΔY_x

then will be shown by the formula $\Delta Y_x = \frac{E_x}{S_x}$. If the autonomous

increase in exports is £100 mln and the marginal propensity to save is $\frac{1}{4}$ then the multiplier is 4 and the increase in X 's income as a result of the increase in exports is £400 mln.

Case II — Domestic Saving plus Induced Domestic Imports

Now let us assume the same autonomous increase in X 's exports as before and the same rate of domestic saving. As national income in X rises under the stimulus of the rise in demand for its exports, a part of the increased income at each successive stage of its circulation besides being saved is spent on goods which are imported, thus passing out of X 's national income stream and constituting a second leakage (M_x). Our formula can now be rewritten as follows in order to take cognisance of both leakages, saving and

induced imports, $\Delta Y_x = \frac{E_x}{S_x + M_x}$. If with our former numerical

¹ An autonomous increase we may define as an increase which is not brought about by changes in the income of the home country. When the demand for home exports rises this constitutes the 'injection'.

² The subscript is to denote the country concerned.

example we have a 'marginal propensity to import',¹ of one fifth then —

$$\Delta Y_x = \frac{100}{.25 + .2} = \text{£}222.22 \text{ mln}$$

This takes care of two major leakages but it does not exhaust the possibilities.

Case III — Case II plus Induced Reduction of Foreign Purchases

Consider once again the situation as in Case II. An initial autonomous increase in exports creates new income in X , but, if it is a truly autonomous increase in exports, it will have diminished incomes abroad by E_x , the amount of the increment. This has the effect of reducing demand for X 's goods in W (the rest of the world) as incomes in W fall. Let us call this repercussion in W , xR_w . From X 's point of view this repercussion (reduction of exports from X to W) is really a third leakage which must be added to the other two in order to give a correct formula for calculation of the eventual increase in X 's income. This formula now becomes —

$$\Delta Y_x = \frac{E_x}{S_x + M_x + {}^xR_w}$$

If we suppose that for any fall in W 's income the citizens of W reduce their demand for X 's exports by $\frac{1}{50}$ th then we may calculate our numerical example as follows —

$$\Delta Y_x = \frac{100}{.25 + .2 + .02} = \text{£}212.77 \text{ mln}$$

What is the adjustment effect of all this on the balance of payments? This is easily seen if we recur to our basic identity that *ex post* the new injection equals the sum of the leakages or withdrawals from the income stream. Here our injection is an autonomous increase in exports. We have but to examine the nature of the leakages to whose sum it is necessarily equal. Assuming X 's balance of payments to have been initially in equilibrium the initial autonomous increase in X 's exports gives rise to a favourable current

¹ The 'marginal propensity to import' may be defined as $\frac{\Delta M}{\Delta Y}$ that is the proportion of an increase in national income which is spent on imports.

account balance of £100 million for X . The final effect on income is an increase of £212.77 mln, which shows a multiplier of just over 2. The leakages from the income circulation have been made up as follows:

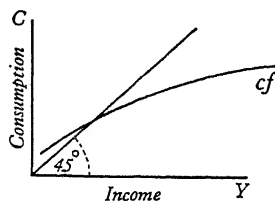
			<i>As part of X's income</i>	<i>As % of total leakage</i>	<i>As money value</i>
Domestic saving	S_x	-	25	53	£53 mln
Induced imports	M_w	-	2	43	43 mln
Foreign repercussion	xR_w	-	02	4	4 mln

From these leakages we can see how adjustment to X 's balance of payments to offset the original increase in exports of £100 mln may be made. Foreigners, under the influence of reduced incomes, cut £4 mln off their imports from X . As X 's national income rises imports into that country rise by £43 mln. The remaining £53 mln is then left to be settled either by loan, or by transfer abroad, and for this savings of £53 mln are available out of the increase in income. Thus by these adjustments, all of which are brought about by the income change resultant upon the original increase in X 's exports, the balance of payments may be restored to equilibrium.¹

Some further consideration of the trade repercussion item is called for. We have already defined this as the fall in W 's imports which occurs as a result of the decline in W 's income as W 's foreign balance with X worsens in response to X 's increase in exports. This oversimplifies the matter. In X as income rises the rate of saving is likely to increase, and in W the rate of saving will probably decline as income falls.² The fact of increased saving in X tends to

¹ It will be observed that in the above example complete adjustment of the foreign balance is only assured if the domestic saving of £53 mln is invested abroad. If this is not done adjustment is incomplete. This case will be dealt with below, cf. p. 44.

² This follows from the normal shape of the consumption function which rises less steeply as income increases. In other words the marginal propensity to consume which is measured by the slope of the curve, falls off as we move to the right along the Y axis. This means that the marginal propensity to save increases. Opposite reasoning can be applied to the case of a fall in income.



curtail X 's induced imports from W and thus reduces the aid which these induced imports give to W . At the same time W 's fall in saving tends to offset the decline in its imports from X . Thus the ultimate repercussion effect is one in which xR_w is corrected to make allowance for these changed rates of saving and the formula for the trade repercussion in W becomes $M_w \frac{S_x}{S_w}$ where M_w is the induced change in W 's imports, S_w is the induced change in W 's saving, both expressed in terms of W incomes.

Let us now summarise the argument for the general case where there are trade and income reactions in both countries. The increment (or decrement) of income (ΔY) brought about by an autonomous increase (or decrease) in the balance of trade (E) is always E times the multiplier k , k being the reciprocal of the aggregate value of all the leakages. We can then state the formulae for income changes in X and in the rest of the world W as follows:

$$\Delta Y_x = E_x \cdot \frac{1}{S_x + M_x + M_w \left(\frac{S_x}{S_w} \right)}, \text{ and}$$

$$\Delta Y_w = E_w \cdot \frac{1}{S_w + M_w + M_x \left(\frac{S_w}{S_x} \right)}$$

The nature of income effects on the balance of payments should now be clear. An active balance of payments, whether by additional exports or additions to income from foreign borrowing, will create additional income which will be some multiple of the original increase in the balance of payments surplus. How large the multiple will be will depend upon the amount of saving done at home,¹ on the amount of the rise in income which is spent on imported goods and on the trade and income reaction of the rest of the world to the changes inaugurated in the home country. So far as the home country is concerned the rise in income generated by the active balance of payments will tend to bring about an increase in imports and such other changes in the balance of payments as will serve in some measure to adjust the original disequilibrium. But it is appar-

¹ Taxation is included in saving. If it is desired to treat taxation separately from voluntary saving a new leakage, the 'Marginal propensity to tax' $\frac{\Delta T}{\Delta Y}$ denoting the proportion of national income in each period which is withdrawn from circulation by taxation, may be introduced into the formula.

ent from our above example that this adjustment may be incomplete. In fact only a part (£47 mln) of the original increment of £100 mln to X 's balance of payments is offset by additional imports into that country and reduced imports by the rest of the world — this implying an assumed willingness on the part of the surplus country to export the £53 mln of capital available from its savings. For full equilibrium in the balance of payments to be restored through changes in the balance of trade the income effects would require to be supplemented; price effects would have to be invoked, the exchange rate adjusted, or relative levels of prices and costs in the two countries changed either by gold flows or by deliberate governmental action. It can be seen from the formulae which have been evolved and from the table showing the means of adjustment that complete adjustment of the balance of payments by income effects and solely through the export/import relationship in fact depends upon such values of the marginal propensity to import and the foreign repercussion as will produce the appropriate changes in imports and exports as between the two countries. Two conditions must be satisfied: S_x , the propensity to save in X , must be zero, and the remaining terms of the denominator $M_x + {}^wR_w$ must be equal to unity. To the extent that $M_x + {}^wR_w < 1$ income effects will be insufficient to make the adjustment and will require to be supplemented by adjustment through price effects. To the extent that there is some positive value for S_x then the income effect upon imports and exports in the balance of payments will have to be supplemented, either by price effects or by the export of savings from the surplus to the deficit country. These are conditions unlikely to be satisfied in practice.

It is apparent, therefore, that, since the conditions necessary for the complete adjustment of a balance of payments solely by income effects are unlikely to be fulfilled, a model which combines income and price effects is necessary. Such models have been constructed by Meade, Metzler, and others, but they cannot be treated here.¹ We have sought only to show the mechanism through which

¹ Readers who wish for a more detailed discussion of the foreign trade multiplier should consult Kindleberger's *International Economics*, chap. 9; Enke and Salera's *International Economics*, chap. 12; Meade's *Theory of International Economic Policy*, parts II and III; Machlup's *International Trade and the National Income Multiplier*; Schelling's *National Income Behaviour*; and Neisser and Modigliani's *National Incomes and International Trade*. Those who like a diagrammatic treatment should consult R. Robinson's 'A Graphical Analysis of the Foreign Trade Multiplier', *Economic Journal*, September 1952.

income changes affect the balance of payments and to demonstrate that, while the newer income approach greatly enlarges our knowledge of the adjustment process, it must in most cases still rely upon aid from the older classical theory.

When we compare the classical and the income theories of balance adjustment a number of interesting points emerge.

The most obvious reflection is that both theories envisage a more or less automatic process for restoring equilibrium to balances of payments;¹ they differ only in the causal factors which they stress. The classical economists were not unaware of the fact that income changes might influence demand for imports and exports, but they regarded such influences as subsidiary to the major factor of price variation. Nor would modern writers on international trade deny that price changes may serve to influence considerably the ebb and flow of demand. The extent to which the balance of payments is sensitive to price changes forms the subject of one of the most interesting current controversies in economics, whose resolution must await the result of empirical investigation.²

A second feature of the income approach is the light which it throws upon disequilibrium as well as upon the adjustment process. In the first place it necessitates a fresh definition of equilibrium itself. The test of equilibrium must now be whether total receipts from current transactions plus long-term capital imports are equal to total current payments plus long-term capital exports *at full employment*. It is possible that such equality of debits and credits might be achieved and maintained at a level of employment well below that of full employment. In such circumstances the payments equality is being maintained by the low level of income and employment, and any upward movement towards full employment will reveal the potential disequilibrium. In the case of a country already fully employed any attempt to increase domestic income

¹ In one sense, however, the income process is more automatic in that it places no reliance upon banking policy. The classical process does assume strict observance of reserve ratios and reaction by interest rate changes and credit policy to gold flows. The history of the interwar period showed such reactions to be far from automatic — although this in itself does not weaken the classical argument. The potency of income adjustment can be judged from the fact that, on certain occasions, balance of payments adjustment has taken place in spite of simultaneous neutralising action by the central bank to offset the effects of gold flows. For an interesting discussion of this point see F. Paish, 'Banking Policy and the Balance of International Payments', *Economica*, November 1936.

² Cf. pp. 58-71 below.

still further will, according to the marginal propensity to import, cause an increase in imports and create a passive balance of payments for the country concerned. The reaction of income changes on the balance of payments becomes of great importance in a world where governments are pledged to maximise domestic incomes by full employment policies. These policies will influence foreign balances and the decision of which is to be paramount, maximising home national income or adjusting income by fiscal measures in order to secure foreign balance adjustment, becomes acute. We can, by reference to income analysis, as readily understand the effect of autonomous foreign balance changes on income as we can understand the adjustment of the foreign balance through income changes. It is therefore possible to come to grips, using the income analysis, with the problem of international propagation of depressions — this in turn leading the way towards policy measures of an international character for the preservation of full employment.

The major defect of the classical theory is its lack of realism, for, with its reliance on a simple chain of cause and effect, it makes no allowance for the various conditions under which the adjustment process must operate.¹ This does not imply that the income theory takes account of all the extraneous factors. It does not. But it places in our hands a tool with which a far wider range of conditions and problems may be analysed. The great need is for a synthesis of the income view of adjustment with what is of value in the older theory. The assumption, which is made in income theory, that, up to the level of full employment, prices in the economy do not rise is not true in practice. Scarcities and bottlenecks in the supply of both goods and factors cause prices to move upwards long before full employment is reached and there is still great need to consider the effect of price changes on the foreign balance and what reactions upon the income process these may have. Moreover, although governments are not likely to seek price changes with the object of influencing the foreign balance, one weapon remains in their hands the potency of which it is hard to assess — the alteration of relative prices of imports and exports by a variation in the exchange rate. In so far as classical ideas may still motivate the policies of governments with respect to their balances of payments it will be through this means.

¹ For example the level of employment in the countries concerned.

Thus far we have been concerned with the abstract problem of balance adjustment and of the forces which bring about adjustment in a capitalist world of nation states.¹ In the actual conduct of affairs governments seeking adjustment to their foreign balances may perhaps rely on invoking automatic forces either by pursuing policies to deflate or inflate domestic prices and incomes or by altering the parity of their currency,² or alternatively they may have recourse to direct supervision of foreign exchange transactions in order to control the supply of and demand for the currency. Direct governmental interference both with foreign trade and with the finance of foreign trade has in late years become general among the great economies of the world.³ The direct control of imports, either by quota or embargo, the control of invisibles such as tourist outlays, the conclusion of bilateral trading agreements, exchange control over current and capital items and the use of multiple exchange rates, have all passed from the stage of appearing novel to that of being a normal part of the international monetary scene. Such measures cannot be described as equilibrating. They may for a time ameliorate or conceal disequilibrium but that remains until other action is taken to correct it. The very presence of controls and restrictions on trade may in itself be taken as evidence that potential disequilibrium exists. All this is not to say, however, that government intervention of another kind may not be beneficial in helping to bring about long-term payments equilibrium. In two ways positive government action may be of assistance. Firstly, a government may through its industrial policy encourage a change in the structure of its country's trade, causing a greater volume of exports to be diverted to this or that country, stimulating the home production of substitutes for imports and causing investment to be undertaken in those home industries whose expansion is likely to influence the country's foreign trade position. Such policies still leave the actual conduct of trade and payments untrammelled by regulation and are of such a nature as not to invoke reprisals from other governments. Secondly, governmental policies may seek to facilitate

¹ We have assumed that there is a hypothetical position of stable equilibrium about which the system tends to fluctuate. The truth of this assumption will be discussed later.

² That is altering the exchange rate.

³ Only five countries were listed by the IMF in March 1947, as not employing exchange control — the United States, Mexico, El Salvador, Guatemala and Panama. At present 45 of the 56 members of the Fund still avail themselves of the transitional arrangements under Article XIV to maintain controls.

the flow of international long term investment¹ for, by so doing, a great contribution to balance of payments equilibrium may be made. The part played by European overseas investment in the second part of the nineteenth century and the contribution to balance of payments equilibrium which was made by highly sensitive capital markets can scarcely be overestimated.

In seeking for theoretical guidance to our judgement of international economic and monetary policies we find ourselves faced with an issue of fundamental importance. This lies in whether governments in seeking to reconcile their policies for international and for domestic equilibrium choose to make use of the processes of price and income adjustment which we have described or whether they choose to rely on direct controls over trade and payments. In seeking an answer to this problem we must examine further the process of adjustment as effected by price changes through adjustment of the exchange rate. With every major economy committed to the pursuit of high levels of income and employment and with growing knowledge of the means to procure them, it is through such changes that we must expect the older liberal methods now to be applied. Should we find that the argument goes against exchange rate variations then a step has been taken towards the acceptance of direct control of the balance of payments as inevitable.

¹ The problem of facilitating the flow of long-term capital investment which is equilibrating, while controlling short term funds movements, which may be a source of instability, is not an easy one.

CHAPTER 3

THE EXCHANGE RATE

I

THE gold standard provided a system of adjustment whereby international differences in price/cost structures were removed by changes in the domestic price levels of surplus and deficit countries — these in turn invoking the appropriate shifts in demand for imports and exports. Exchange rates were regarded as fixed and immutable. With the fall from grace of the gold standard in the 'thirties opinion moved to the view that changes in relative prices were best secured by variations in the exchange rate. Internal stability of prices and employment could then be sought through domestic policy and exchange rate movements would determine the relationship of internal and external value for the currency. In the main this view of the role of the exchange rate still survives, although it has undergone considerable modification and the efficacy of exchange rate variations as a means of preserving equilibrium is now called seriously in question.¹ (Such criticisms will be dealt with in their place.) The international system which was established in 1944 at Bretton Woods makes use of exchange variations and the IMF is empowered to sanction changes of rate when these are necessary to adjust a so-called 'fundamental disequilibrium'. Since this term is not defined we must try to gain some idea of its possible significance and it is best to attempt this by first obtaining a working definition of the equilibrium exchange rate.

It is possible to regard the international system as one which is held in equilibrium by a series of equilibrium rates of exchange.

¹ Apart from the years immediately after the First World War the use of exchange rate variations as a general equilibrium device dates from 1931, the year of Britain's departure from gold. From then until 1939 the sterling exchange rate was left to find its own level, at first freely and after 1932 with the intervention in the market of the Exchange Equalisation Account. In 1936 the Tri-Partite Monetary Agreement established certain principles for the regulation of exchange rates and these remained operative until the outbreak of war in 1939.

For any country then the equilibrium rate is 'that rate which, over a certain period of time, keeps the balance of payments in equilibrium'.¹ This definition is, however, too simple to be of use and requires amplification.

The time element is stressed and rightly so for it is all important. Clearly no stable rate can reflect the equilibrium of day to day changes occasioned by delays of settlement and the like. To reflect such changes an equilibrium rate would have to change hour by hour and by its changes would create such instability as would negate the whole principle of equilibrium.² We are then forced to lengthen our time-focus and consider a longer period over which the rate may maintain balance of payments equilibrium. For any period less than a year seasonal influences act upon the balance and the equilibrium rate would require to move upward or downward in response to these influences. The period of time envisaged must therefore be long enough to allow these seasonal fluctuations to work themselves out.

In lengthening our standard period to at least a year we have eliminated short-period and seasonal influences, but having gone so far, it is arguable that we should go further and remove the influence of the business cycle itself. By considering a period as long as a decade it would be possible to eliminate all the influences making for periodic recurrent fluctuation of balances of payments. But to extend our standard period thus seems inadvisable. In ten years many secular changes may occur and only under static conditions could a rate be stabilised for so long. It seems more fitting to name two or three years as the duration of the period. This allows adequate time for adjustments attendant upon an initial alteration of rate to be absorbed by the economy.³

¹ Cf. Ragnar Nurkse, 'International Monetary Equilibrium', *Essays in International Finance*, no. 4, Princeton University 1945, reprinted in chap. I. *Readings in the Theory of International Trade*, Philadelphia 1949. The following discussion follows the lines of Nurkse's discussion.

² Although freely fluctuating exchange rates are sometimes advocated as an adjustment mechanism we can safely say that by this phrase even their most ardent advocate envisages rates which show only long-period fluctuations — such short-term movements as we refer to above being nullified by the action of stabilisation funds. The whole question of fluctuating rates is considered in chap. 4, (iii).

³ Prof. Nurkse would fix his standard period at between five and ten years. Thus, if a given rate of exchange enables a country's balance of payments to preserve balance over such a period then that rate may be regarded as an equilibrium one.

It is doubtful if Nurkse is justified in thus extending the standard period. It is true, as he points out, that certain primary commodity producing countries are

For changes in the balance of payments within the standard period (of three years) temporary deficits and surpluses must be met by transfers of gold, convertible currencies or international borrowing facilities. The making of such settlements is the prime function of international liquidity. If the rate is an equilibrium rate the end of the standard period will find the reserves of the country concerned unchanged as compared with the beginning of the period. We can therefore restate our definition and say that an equilibrium rate is that rate at which, over a standard period of three years, 'there would be no net change in a country's reserves of international means of payment.'¹ Clearly the longer we make our standard period the larger the amount of reserves (or international liquidity) which the international economy requires for adjustment purposes. Or conversely, 'the greater the stock of international liquidity held by any country and by countries in the aggregate the less will be the need for changes in exchange rates.'² A larger world-holding of international liquidity would be necessary to maintain stable rates of exchange over the whole business cycle than to meet only seasonal and short-term fluctuations.

In speaking of equilibrium in the balance of payments we must be careful to define what is included in the balance. Clearly gold and currency reserve transfers must be excluded since, with their inclusion, balance in the account is automatic and continuous. Movements of short-term funds must also be excluded, whether they be genuine equilibrating movements made, as was the case under the gold standard, in response to interest rate differentials or destabilising movements of the 'hot money' type. If, as in the first case, a deficit country covers its deficit by an inflow of short-term

subject to cyclical influences on their balances of payments, and that, for them, a lengthening of the standard period is appropriate. But for industrial countries cyclical influences upon the balance of payments are less apparent and a standard period of about two years would suffice. Moreover by fixing his standard period so as to include the whole business cycle Prof. Nurkse tacitly assumes that the effects of the cycle will be mild and that its ebb and flow will leave balances much as they were. But in the post-1945 world of fully employed economies bordering upon inflation and with small reserves, each swing of the cycle causes external disequilibria which are often beyond the power of countries to adjust without a change in the exchange rate. While Prof. Nurkse's standard period of five to ten years satisfies intellectually in that it eliminates all recurrent influences upon the rate, it is too far removed from present reality. It is even reasonable to argue that economies may use variations in their exchange rates as a contra-cyclical weapon.

¹ Cf. Nurkse, *op. cit.*, p. 7.

² Cf. *ibid.*, p. 7. The significance of this for policy is evident. If it is desired to create an international payments system with stable exchange rates provision must be made for an adequate stock of international liquidity.

funds this has the same balancing effect as a gold outflow. Since the funds are liable to withdrawal they are a liability and are best regarded as a negative gold reserve and thus a reduction of the country's international liquidity. If the funds are of the 'hot money' type, which proved so unstabilising during the 'thirties, their movement should be prevented by direct control.¹ All other items of the balance of payments should be included.

Our definition of the equilibrium rate is not yet complete. It is possible for a country to sustain a spurious balance in its international payments at a rate other than the equilibrium rate in two ways: either by direct controls which achieve an artificial balance through the restriction of imports or by tolerating such a degree of under-employment as serves to reduce the demand for imports to the level appropriate to an accounting balance.² Both of these conditions must be excluded. We are examining the conditions of equilibrium exchanges under free movement of goods and currencies, and can allow only the existence of such minor restrictions and frictions as are generally agreed as desirable;³ and the maintenance of a high and stable level of employment is now such a generally accepted policy aim of the great economies that we must regard it as certain that under-employment would no longer be tolerated in the interest of balance of payments adjustment.

We may now restate our definition in order to take account of the foregoing conditions. An equilibrium rate is that rate which, over a standard period, during which full employment is maintained and there is no change in the amount of restriction on trade or on currency transfer, causes no net change in the holdings of

¹ There is general agreement even among the most liberal economists that short-period funds movements should be controlled to prevent a recurrence of the unstabilising 'hot money' movements of the 'thirties. Even the IMF, which is anxious and is pledged to encourage the removal of restrictions on international trade, agrees to the maintenance of controls over short-term capital movements.

² The example most often quoted in this connection is that of Great Britain between 1925 and 1931. It is generally agreed that during this period the pound was approximately 10 per cent over-valued but in spite of this a current account surplus was maintained throughout the period and there was no gold outflow. This was made possible, however, by Britain's relatively high unemployment during this time.

³ Clearly some element of interference with international trade is inevitable. Countries will always wish to exclude certain goods (if only on moral grounds) and with the growing complexity of international economic relationships, even the allowable minimum of control must be considerable. What is of course vitally necessary, is that, over the standard period of three years, the background of trade and currency control be unchanged. It is when some basic change in a balance of payments item is promptly countered by some direct measure of control that the rate which is thus maintained is not a true equilibrium one.

gold and currency reserves of the country concerned. And, moving from the case of a single country to that of a world system, we may 'define an ideal system of equilibrium rates as one that maintains the accounts of all countries simultaneously in equilibrium when all countries simultaneously are free from mass unemployment on the one hand and inflation on the other'.¹ These definitions may, at first blush, seem somewhat cumbersome, but they are certainly of use for policy, for the forming of judgements upon given exchange rate situations and for considering critically the sort of equilibrating payments system we have been trying to construct since the Second World War. From them it is possible to formulate principles of exchange adjustment. The role and importance of international liquidity becomes apparent; and the level of employment and direct control of foreign trade are each brought into perspective in their relation to international equilibrium.

The balance of payments method of defining the equilibrium exchange rate has now become the accepted one. It is on such a basis that arguments for and against an alteration of rate would now be carried on. The method is, however, qualitative rather than quantitative. It enables one to inspect critically a rate already in operation and see whether it satisfies certain accepted conditions² but it does not serve us if we wish to answer the question: what, in precise figures, should be the rate between currencies A and B?³ If

¹ It is interesting to compare this definition with one given by Keynes as far back as 1935. He said: 'We have to consider on the one hand a country's balance of payments on income account on the basis of the existing natural resources, equipment, technique and costs (especially wage costs) at home and abroad, a normal level of employment, and those tariffs, etc., which are a permanent feature of national policies; and, on the other hand, the probable readiness and ability of the country in question to borrow or lend abroad on long term (or, perhaps, repay or accept repayment of old loans) on the average of the next few years. A set of rates of exchange which can be established without undue strain on either side and without large movements of gold (on a balance of transactions) will satisfy our conditions of equilibrium.' Cf. *Lloyds Bank Review*, October 1935, p. 528.

² At the risk of being repetitive we will set down concisely the requirements of an equilibrium rate: (i) the balance of payments must be balanced over a standard period of about three years without any net change in reserve or gold holdings; (ii) this balance must be attained without resort to direct import controls; and (iii) the balance must not be at the cost of either domestic unemployment or inflation.

³ This case is not so hypothetical as it might seem. At least twice in the present century the major economies have faced the problem of fixing an external value for their currencies, in 1918 and 1945. The approval of initial parities by the IMF in 1946 demanded an accurate estimate to be made of all members' exchange rates. Again, a country contemplating devaluation of its currency must decide the figure to which it will devalue.

the settling of external currency values is to be anything more than a process of trial and error some quantitative method of rate determination must be available.

Some thought was given to this problem during the 1914-18 War, when it was apparent that, with the return of peace, a restoration of the gold standard would bring the contingent problem of calculating new parities of the main currencies with gold so as to take account of the changes in prices and costs since 1914. In 1916 Gustav Cassel, basing his ideas on some of the writings of Ricardo and Wheatley during the Bullionist controversy a century earlier, put forward a simple formula for calculating the relationship between relative price-levels, which he called the 'purchasing power parity theory'.¹ Originally put forward as an *ad hoc* theoretical contribution to the devaluation versus deflation controversy of the immediate postwar period, the purchasing power parity doctrine came to be much used in the various discussions of exchange rate policy which took place in the later 'twenties and in the 'thirties, and was often applied to situations for the analysis of which it was totally inadequate. According to this theory the equilibrium rate of exchange between two currencies is such as gives equality in their purchasing power. A foreign currency is demanded because it gives purchasing power over goods in another country. If the rate of exchange is such that with a given amount of money more goods can be obtained in the foreign country (by buying the foreign currency and using it to buy goods there) than could be obtained at home then the foreign currency is undervalued and pressure to obtain the currency to buy goods which are, because of the rate, relatively cheaper abroad will force the rate upwards. Conversely, if the rate is such that, with a given sum, fewer goods can be obtained in the foreign country than at home then the foreign currency is overvalued and a low demand for it will cause the exchange rate to fall. The equilibrium level for the rate will then be such as will provide no incentive to the nationals of either country to exchange their currencies and import goods from the other rather than obtain exactly similar goods at home.² Trade will be

¹ Cf. Gustav Cassel, *Memorandum on the World's Monetary Problems*, International Financial Conference, Brussels 1920. For a résumé of the evolution of the purchasing power parity doctrine see Jacob Viner's *Studies in the Theory of International Trade*, New York 1937, pp. 379-87.

² This is merely another way of saying that converted at the equilibrium rates the prices of identical goods are equal in all countries. If a coat costing £7 in

limited to goods in which one or other country has a cost advantage.

The theory has two forms, an absolute and a comparative, the former dealing with the determination of the rate at a given point in time, the latter with movements in the rate actuated by movements of price-levels relative to some previous date. As one cannot define the value of a currency save in a relative sense¹ it is only the comparative form which has significance. Thus we calculate the equilibrium exchange rate by multiplying a previous existing equilibrium rate of exchange by the relative change in the two price levels since the date on which that rate ruled. Since movements of price-levels are statistically expressed in index numbers

the formula for the calculation of the new rate is $R_t = R_{t-1} \times \frac{P_1}{P_2}$

where R_t is the new rate, R_{t-1} is the rate one period ago, P_1 is the index number change for the currency of the country in terms of whose currency the exchange rate is expressed, and P_2 is the index number change in the value of the other currency.

The defects of the purchasing power parity theory are too widely known to require exhaustive discussion. In its absolute form the doctrine is a truism, if one assumes a costless flow of commodities from one country to the other. It breaks down completely when one recognises the existence of numerous frictions to such a flow (e.g. transport costs, tariffs, etc.) and the existence of that large category of goods and services which do not, and by their nature cannot, enter into international trade. Moreover, the theory is applicable only to commodity trade which forms but a part, albeit an important part, of the balance of payments. When one turns to the comparative form the theory fares little better.² The necessity of using index numbers in calculation, besides introducing all the defects to which these are subject, leaves the difficult decision of

London sells at 7,000 frs in Paris then the sterling/franc rate is 1,000 frs = £1. Under such conditions it would clearly not pay either country to import coats from the other. This applies *a fortiori* if one considers transport costs or tariffs.

¹ Clearly one cannot satisfactorily measure the value of money at a given moment of time. One can only say that a unit of currency buys x units of this or y units of that. When one says, however, that today a currency unit buys x units of bread and last year it bought $x + z$ units of bread the information is meaningful for we know that, in terms of bread, the value of the currency has fallen and the price of bread has risen. We can then compute the amount by which prices have risen relative to some given time in the past.

² It must be assumed that no fundamental changes have occurred in the structure of trade between the two countries; that their national incomes remained constant and that no major changes in tariffs or import controls have taken place throughout the period.

choosing indices appropriate to the task in regard to coverage, base year and method of calculation. But most serious of all the search for a value for a new equilibrium rate by means of this formula assumes that the former rate was a true equilibrium one. In this way the calculation of the new is subject to all the defects and inaccuracies of the old. Such a case builds up against the spurious exactness of the purchasing power parity theory as has caused it to be almost completely discredited in recent years. It is a very imperfect means of calculating the equilibrium exchange rate between two currencies.

Nevertheless a certain pragmatic case can be made for the theory. It is imperfect, but it remains the only way in which we can calculate a figure for the rate of exchange, and, knowing the difficulties of interpreting it, we may make cautious use of it.¹ Used in conjunction with the qualitative criteria which have already been stated the theory may be a useful check either upon an existing rate or upon one which is contemplated, and in default of a better we must use it — albeit with circumspection. The serious defect, that the formula deals in relative terms which carry forward into the new calculation the defects of the base period, can, in part, be offset by submitting the base year exchange rate to searching qualitative scrutiny. So long as we do not dogmatise on the basis of such calculations or regard them as anything more than rough guides no harm will accrue from the use of purchasing power parity² and since no other tool is available we must perforce use the only one which is to hand.³

¹ If the obvious inferences from purchasing power parity had been drawn in 1918 and after, disastrous errors in establishing postwar parities of exchange would have been avoided. Metzler points out ('Exchange Rates and the IMF' in *International Monetary Policies, Postwar Economic Studies* no. 7, September 1947, Board of Governors of the Federal Reserve System) that much of the discredit under which the theory has fallen springs from its improper use. For general price-level movements due to inflation (as over a war period) the theory has use. During normal peace time, however, balance of payments instability comes from relative price changes with which the theory by reason of its reliance on index numbers is unsuited to deal. While useful for a general argument such as whether currencies should be devalued after a war, it was totally unfitted (and was not intended by Cassell) to serve in analysis of the complex international problems of the 'thirties.

² There has been a tendency in recent years to permit the guarded use of the parity formula. Haberler, Metzler and Samuelson have all supported its use as an estimate or check. Cf. G. Haberler, 'The Choice of Exchange Rates After the War', *Amer. Econ. Rev.* vol. 35, no. 3, and P. Samuelson, 'Disparity in Postwar Exchange Rates', chap. 22 of *Foreign Economic Policy for the United States*, ed. by Seymour Harris, Cambridge (Mass.) 1948.

³ A danger in using the purchasing power parity theory to calculate new

We are now in a position to draw from what has preceded the broad principles which may be of use in approaching the problem of exchange adjustment. In the interests of brevity we shall set these out *seriatim*.

1. In the selection of a rate of exchange between two currencies the objective should be to select that rate which, in consideration of probable future conditions (including governmental policies and programmes), promises an approximate long-term balance in the country's balance of payments, and which will provide cost and income relationships which are consistent with high levels of trade at full employment. Moreover, the rate must be such as may prevail unsupported by exchange control.

2. The frequency with which exchange rates are adjusted must be, in part, determined by the volume of international liquidity held by the main economies of the world.

3. A concrete rate must be decided upon and it must be decided how much reliance should be placed upon purchasing power parity calculations. Since for no other method are data available the parity formula may be used, providing that the suggested new rate is submitted to searching scrutiny and qualitative criticism.

4. Care must be taken in deciding whether, with a given capital flow, a rate is really maintaining equilibrium. Should the capital flow be steady and predictable in amount, then it is not destabilising, but if it is erratic and unpredictable then the rate should be such as will balance the current account without reliance upon the capital flow.

5. In considering under what circumstances a country should be allowed to change its rate the simple criteria should be applied that devaluation should only take place (a) to meet a passive balance of payments, or (b) to enable the removal of direct controls or import tariffs by the aid of which a balance has hitherto been preserved.

The last of these conditions precludes the use of devaluation to cure unemployment within the country if the country has a balance of payments surplus, as under such circumstances domestic monetary and fiscal expansion would cure the unemployment and

exchange rates following a war lies in the fact that indices at such a time are likely to reflect not true market prices, but prices which are controlled. In settling rates for a long period there is then the added difficulty of guessing what prices would actually rule if all controls were abolished, for it is the final and uncontrolled prices which must determine the nature of an eventual equilibrium rate.

scheme, the demand reactions to price changes. Whether we assume a gold standard world or a world of free exchanges matters little, for in the former case it is the prices of the goods themselves which vary, while in the latter it is their external price which varies through movements of the exchange rate. Fundamentally the process is the same — demand reaction to price changes ensures the stability of the equilibrium. Thus price elasticities of demand and supply are of primary importance in the classical analysis of adjustment.¹

Consider the case of balance of payments adjustment by a change in the exchange rate. The efficacy of a depreciation necessarily depends upon what happens to the quantity

(Value of Exports MINUS Value of Imports)

which may be considered either in terms of foreign currency throughout or in terms of home currency throughout. But in examining the reactions of demand to the changes in prices wrought by the depreciation both the price changes in home and in foreign currencies must be considered, for both serve to influence the final value of the trade balance. The examination of this expression clearly involves the consideration of two sets of forces: firstly, the complex relationship of elasticities of demand for and supply of imports and exports; and secondly, the income effects which result from changes in the demand for goods and services after the depreciation takes place. Consider each of these sets of forces in turn.

When a depreciation takes place the immediate changes involved are as follows:

¹ Since we have not hitherto used the term 'elasticity' it is as well now to define it. Three elasticities will concern us: price demand elasticity, price supply elasticity, and income elasticity of demand. The price elasticity of demand is, approximately, the ratio of the percentage change in the quantity demanded to a *small* percentage change in price. Thus if a change in price of 3 per cent is accompanied by a change in demand of 3 per cent in the opposite direction elasticity is said to be unity. In cases where elasticity is greater than unity we speak of demand as 'elastic'; where it is less than unity we speak of it as 'inelastic'. It should be noted that, when assigning numerical values to elasticities, the value is always negative — this following from the fact that price and quantity have different signs. In order that elasticity shall have a positive sign it is conventional to multiply the true elasticity by -1 .

In the case of supply, the elasticity of supply is measured by the ratio of a small percentage change in the quantity supplied to a small percentage change in price. Here the changes in price and supply bear the same sign, so that elasticity of supply is always a positive quantity.

The income elasticity of demand is the ratio of the percentage change in the quantity purchased to a small percentage change in income.

- (a) in terms of the home currency — the price of exports is unchanged, while the price of imports rises more than in proportion to the depreciation; and
- (b) in terms of the foreign currency — the price of exports falls proportionately to the depreciation, while the price of imports remains unchanged.¹

In determining how these price changes affect the trade balance four elasticities are relevant. For the depreciating country these are: (i) the foreign demand-elasticity for exports, (ii) the domestic supply-elasticity of exports, (iii) the home demand-elasticity for imports, and (iv) the foreign supply-elasticity of imports. Consider first the demand elasticities.

If we assume that there is no initial change in the price of internationally traded goods in their own currencies the way in which buyers react to price changes after depreciation depends upon their elasticity of demand. If the depreciation is to be effective the amount received by the depreciating country in foreign currency for the sale of exports must be increased (or at least held constant) and the amount due in foreign currency in payment for imports must be reduced. For the former condition to be fulfilled the elasticity of foreign demand must be greater than (or equal to) unity;² for the latter it is sufficient that the elasticity of demand for imports should have any value greater than zero, for the foreign currency price of imported goods remains initially unchanged and any reduction of the volume of demand will reduce the foreign currency import bill. The higher the value of the elasticity of demand for imports the greater the reduction in foreign currency liability.³

¹ For example, when in September 1949 Britain devalued the pound from £1 = \$4 to £1 = \$2.8, a reduction of 30 per cent, the rise in the cost of imports was 43 per cent. According to whether transport costs of exports and imports are borne in the buyers' or the sellers' currency these changes will be subject to slight adjustment.

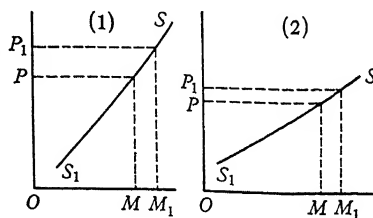
² Since the depreciation will have had the effect of reducing export prices in foreign currencies, an elasticity of demand of unity will be required in order to raise total export value to its former level in foreign currency, and only if the elasticity is greater than one will total export value increase.

³ What determines the nature of these demand elasticities? So far as the foreign demand for exports is concerned the elasticity is determined by the nature of the export good concerned and by its ability to compete with similar goods in the country to which it is exported. If we consider the export of Scots whisky to the United States for example, the elasticity of demand will depend upon (a) the American reaction to a fall in the price of whisky in general, and (b) on how ready Americans will be to purchase Scots rather than American whisky when the former becomes relatively cheaper. In this example the elasticity would be

But the supply conditions of imports and exports are also relevant and affect the ultimate change wrought by depreciation upon the trade balance. On the side of exports, if the demand for the exports of the depreciating country has unit elasticity, so that the foreign currency expenditure remains constant, then the value of exports (in terms of home currency) is unaffected by the elasticity of supply of export goods and increases proportionately to the fall in the exchange rate. If the foreign elasticity of demand for exports is less than unity then the increase in the value of the home country's exports will be greater, the less is their elasticity of supply and the increase in the value of exports will be greatest when this elasticity of supply is zero. When the foreign demand is of greater than unit elasticity, however, the increase in the value of exports is greater, the greater is the elasticity of supply of these exports. The role of changes in the supply price following upon changes in demand should be clear.¹ When the elasticity of demand is small, the value of exports, and hence the depreciation, is favoured by a low elasticity of supply which, by increasing the supply price, in part offsets the adverse effect of low elasticity of demand. While when the change in demand and output is great the value of exports will

be high, Americans being ready to purchase increasing amounts of luxury commodities as their price falls and also holding the not unreasonable view that Scotch whisky is of high quality and more desirable than American near substitutes. In general the demand for manufactured exports is elastic and becomes more so when they are of a luxury character, while the demand for food and raw materials is usually inelastic. A country then (such as Britain or Germany) which exports high quality manufactures and imports mainly primary products is likely to have an elastic demand for its exports and an inelastic demand for its imports. Depreciation is most likely to be successful in a country in which an elastic demand for its exports is accompanied by an elastic demand for imports. This condition is not often satisfied.

¹ It follows from the traditional shape of the supply curve which slopes upward and to the right. An increase in price from OP to OP_1 will increase output from OM to OM_1 . Conversely a reduction in price will lower output. The extent of the output change for a given change of price depends upon the elasticity of supply. The more elastic the supply (as in Case 2) the smaller the price change. Since the slope of the supply curve reflects basic cost conditions we can then say that, for countries whose output is mainly of primary products the supply will be relatively inelastic and the price change for changes in demand may be considerable. For manufacturing countries the supply will be more elastic and domestic prices will react less to changes in external demand.



maximise itself when the supply elasticity is infinite and is not retarded by a rising supply price to curtail demand

On the import side the supply elasticities are equally important. For example when the foreign supply is infinitely elastic there is no change in the foreign price and the home import price rises more than proportionately to the depreciation. But, if the foreign supply is inelastic, the foreign supply price falls with a contraction of output and the home import price rises less than in proportion to the depreciation. When the foreign supply elasticity is coupled with the elasticity of home demand for imports we find that the depreciation is favoured when with a home demand for imports of less than unit elasticity there is coupled a low elasticity of foreign supply and when with a home demand for imports of more than unit elasticity is coupled a high elasticity of foreign supply.

Not only do the supply elasticities have a direct effect upon the values of the imports and exports of the depreciating country but, in so far as the initial price changes enable export goods to compete with the domestic goods of the receiving country and thus reduce the demand for them, it alters the prices of these goods as well. In so far as a fall in the demand for imports diverts home demand to domestically produced competing goods it increases the prices of the latter. Thus the supply elasticities govern not only the prices of imports and exports of the depreciating country but also the prices of goods competing at home and abroad with these imports and exports. The demand changes invoked by the primary changes in import and export prices must be subsequently adjusted to reflect these secondary changes in the price of competing products.

In general the greater the elasticity of supply of these competing goods the more effective the depreciation is likely to be. In the case of export goods the demand for which is extended by the fall in their foreign currency price, the extension of demand will be greater if the elasticity of supply of goods produced in the foreign country is great — that is, if the diversion of demand away from them invokes no fall in price. In the case of a diminished demand for imports this will be greater if the elasticity of supply of home produced goods is great so that the diversion of demand away from imports does not raise the price of home-produced goods.

We are now able to summarise the factors upon which the efficacy of a depreciation depends. Success requires that:

- (i) Home demand for imports should be elastic. It will be so if
 - (a) home demand for the type of goods imported is elastic;
and
 - (b) the supply of home-produced goods competing with imports is elastic.

The more elastic the supply of foreign goods the more favourable will be the result of devaluation.

- (ii) Foreign demand for exports is elastic. It will be so if
 - (a) foreign demand for the type of goods exported is elastic;
and
 - (b) the supply of foreign produced goods competing with exports is elastic.

The more elastic the supply of goods for export the more favourable the effect of the depreciation.

(iii) The deficit in the balance of trade should not be large. If imports greatly exceed exports then the percentage changes to which both are subject as a result of the depreciation will not serve to remove the imbalance. For example if the elasticities are such as to provide an equal percentage increase in the home currency values of imports and exports, this involves a larger absolute increase in imports if these exceeded exports in the first place. If the initial deficit is large much higher elasticities will be required to improve the balance of trade.

The interplay of these factors is complex, but it is possible to derive some useful generalisations. If we assume for simplicity that the elasticities of home and foreign supply are infinite then the following facts about the likely effects of a depreciation upon the trade balance are useful.

1. Provided that the elasticity of demand for imports is greater than one a depreciation must improve the balance of trade. The value of imports (in home currency) will fall while, even if the foreign demand for exports is inelastic, the value of exports (in home currency) will be unchanged.

2. Should the elasticity of demand for imports be less than one the balance of trade will improve if the foreign elasticity of demand for exports is more than sufficient to offset the rise in the import bill. In other words the sum of the two elasticities must be greater than some particular level at which the trade balance would be unaltered.

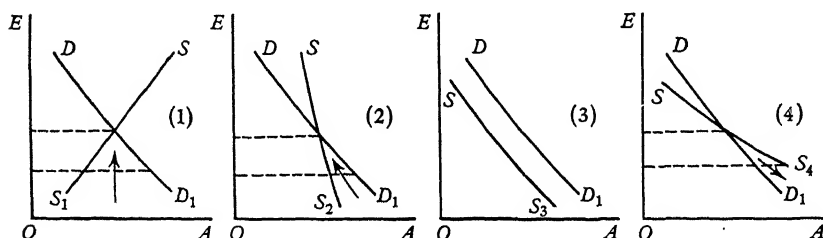
3. From the foregoing it follows that the balance of trade may

improve as a result of a depreciation even if the elasticities of home and foreign demand are each less than one. In fact it can be shown that depreciation will always improve the balance of payments of the depreciating country if the sum of the elasticities of the country's demand for imports and of the foreign demand for its exports is greater than unity. If this sum is less than unity then the balance of payments will deteriorate.

It seems therefore that the classical assumption of a stable equilibrium for the balance of payments is subject to this condition.¹ If the home demand for imports is inelastic and if the foreign demand for exports is not elastic enough to compensate for this (i.e., if the sum of the two elasticities be less than unity) then depreciation will not correct the balance; rather it will worsen it. Any movement away from equilibrium in such circumstances will invoke forces which serve to increase the disequilibrium, rather than to correct it.²

¹ It should be noted that the condition, that the sum of the two demand elasticities is greater than unity, is a *sufficient* but not a *necessary* condition for a depreciation to improve the balance of payments. If we remove the assumption of infinite elasticities of home and foreign supply (under which the above generalisations are made) it is clear that, even if the sum of the demand elasticities is less than unity, improvement of the balance will still take place if the supply elasticities are small. Cf. G. Haberler, *A Survey of International Trade Theory*, p. 39.

² The possibility of instability of equilibrium can be shown diagrammatically. We can consider the balance of payments in terms of demand for and supply of the home currency. Then it follows that the demand curve for home currency will slope downward to the right since a fall in the exchange rate will increase the demand for exports and hence the demand for the home currency. The nature of



the supply curve of home currency is less certain and three possibilities present themselves, according to the nature of the elasticity of demand (ϵ) for imports: (i) where $\epsilon > 1$ a fall in the exchange rate will reduce the value of imports and the curve will slope upwards to the right; (ii) where $\epsilon < 1$ a depreciation will increase the import bill and the curve will slope downwards to the right; (iii) where $\epsilon = 1$ the supply curve will be vertical for the supply will not vary with the exchange rate. It is then possible to show various relationships of these demand and supply curves. If along the vertical we measure the exchange rate (E) and along the horizontal axis we measure the demand for home currency (to pay for exports)

The implications of this for theory are of fundamental importance but the discussion is still *sub judice* and cannot be dealt with here.¹ We must take from the theory what has emerged as proven and assess its implications for policy. These are great. When between two countries, the supply of whose export goods is elastic, the sum of the two elasticities of demand for imports is less than one, then depreciation of the currency unit of either country will not be a solution to the problem of a passive balance of payments. It will widen the trade gap. When the sum of the elasticities is one the size of the gap will not be altered. Only when the sum is greater than one will depreciation be a practicable solution. The greater the excess of the total of the two elasticities over one the more effective depreciation will be in adjusting the balance of payments deficit. If we believe that the relevant elasticities are generally of low value then we are forced to call in question the use of depreciation as a corrective measure, further we must question all foreign balance adjustment processes relying on price changes. It is

and the supply of home currency (to pay for imports) (A), and DD_1 is the demand curve for home currency and is the same in all four cases, then the four diagrams show the possibilities presented by different positions of the supply curve SS . (1) and (2) show conditions of stable equilibrium, any drop in the rate making demand for the currency greater than supply and forcing the rate up again. In (3) the equilibrium is indeterminate, and in (4) the equilibrium is unstable, a reduction of the rate making supply of the currency exceed demand and forcing a further reduction.

¹ Doubts as to the stability of the classical equilibrium have been held for many years. Marshall (cf. *Pure Theory of Foreign Trade*, 1879) toyed with the problem but regarded it as an intellectual exercise having no significance for policy. This view probably sprang from his belief (cf. *Money, Credit and Commerce*, p. 171) that under modern industrial conditions the relevant elasticities were high. The correct conditions of exchange stability were first stated by C. F. Bickerdike in a note 'The Instability of Foreign Exchange' in the *Economic Journal* in March 1920, in which the writer sounded a warning that the post-war depreciation of the £ (from \$4.76 in February 1919 to \$3.81 in December) might not serve to correct the balance of payments deficit of the United Kingdom. Barrett Whale (*International Trade*, London 1934) questioned the natural tendency to equilibrium and spoke of the existence of 'Counteracting forces of a more or less accidental nature'. The subject was sifted by Joan Robinson in her essay on the foreign exchanges published in 1937 in which she reached similar conclusions to Bickerdike but stressed in addition the stabilising role of low elasticities of supply. Lerner (cf. *Economics of Control*, New York 1944, p. 377) stressed the theorem that for a depreciation to be effective the sum of the elasticities of demand for imports and exports should be greater than unity — a theorem which Kindleberger refers to (cf. *International Economics*, 1953, p. 145) as 'The Marshall-Lerner condition'. A. J. Brown in his 'Trade Balance and Exchange Stability' (*Oxford Econ. Papers*, April 1942) reached the same conclusions but added the cheering topical rider that, since Britain's exports are mainly manufactures sold under competitive conditions, the demand for her exports will be elastic. For a formal discussion of the theoretical implications see G. Stuvell, *The Exchange Stability Problem*, Oxford 1951.

of course true that, if in any given case it be known that the elasticities of demand for imports and exports are in total less than one, an appreciation of the rate would then have a correcting effect, but such exact knowledge is not at our disposal. The fact emerges that we based much of our theoretical analysis and our policy thinking on the belief that a balance of payments reacts favourably to a depreciation. Now we are not so sure.

The last word must necessarily lie with the statisticians and economic historians. From the estimates of the relevant elasticities made by the former and from the teaching of monetary history as interpreted by the latter, we must extract such guidance for action as we may. Of statistical estimates there is no lack. Chang, Neisser, Polak, Tinbergen and others have all provided estimates of price elasticities of demand — most of which indicate that, even under favourable conditions,¹ depreciation would prove ineffective. As has been shown price elasticities of imports and exports would require to be, in total, greater than one. The collection of an impressive series of elasticity values, most of which fall between 0 and .5 has therefore been taken to indicate the ineffectiveness of depreciation, and has done much in recent years to undermine the old faith that demand is highly sensitive to price. The theoretical work on foreign balance equilibrium which we have already described caused growing scepticism of the worth of exchange rate variations in the years immediately preceding World War II and the reinforcement given by subsequent statistical studies² to these doubts was considerable. However, in 1950 Guy Orcutt, in a paper which was first prepared as a research memorandum for the IMF, examined the basis upon which these estimates had been made and questioned their trustworthiness. For a variety of reasons³ the

¹ That is, where there occurs no retaliatory action such as a counter depreciation or direct import control by other countries.

² Most of these estimates were made after the war, e.g. Chang — 1945–6; 1946; 1947; 1948. Neisser — 1945 and 1948. Tinbergen — 1937; 1946; 1947; 1948. For a comprehensive bibliography of these estimates see Appendix 4 of Guy Orcutt's 'Measurement of Price Elasticities in International Trade', *Review of Economics and Statistics*, vol. 32, no. 2, May 1950.

³ Orcutt gave five main reasons for his criticism: (i) The estimates have been made on the basis of a narrow range of experience, and assumed important factors, such as incomes, to be constant; (ii) Errors and bias in the available figures of quantities and prices of imports and exports; (iii) Historical price and quantity indices reflect price changes of commodities with very different price elasticities. Since, *a priori*, one might expect prices of goods for which demand is inelastic to change most this may mean that price changes shown in the indices reflect unduly the price changes of commodities with inelastic demands; (iv)

estimates were, he alleged, too low and therefore underestimated the effectiveness of price changes in influencing demand. There was no reason to suppose that depreciation would prove an ineffective corrector of a deficit in the balance of payments. This, at least, left the door partially open: the debate among the statisticians continues and we must await its outcome.

Whatever may be the result of the controversy as to whether demand for imports is or is not price elastic, the history of the inter-war period provides evidence that exchange depreciation does in fact result in expanded exports for the depreciating country. When, after six years with an over-valued currency, Britain left gold in September 1931 and allowed the pound to depreciate, the results were striking. Since 1925 Britain had suffered relative decline as an exporting country and had maintained balance in her foreign account only at the cost of underemployment at home. Following the depreciation she regained her pre-war position relative to Germany, improved her position relative to France and checked the inroads which, during the 'twenties, Japan had made upon her markets. Two years later when the United States devalued the dollar, Britain's export position relative to that country declined. Depreciation was also practised with advantage by certain of the great primary commodity producing countries (e.g. Australia, New Zealand, Argentine). Success in these cases is not surprising. Such countries export primary products the demand for which is likely to be inelastic and import mainly capital equipment and luxury consumer goods for which the demand is probably elastic. Whatever depreciation may do for exports it is almost certain to curtail imports and to this extent have a beneficial effect on the foreign balance. Moreover, the supply of primary product exports is in the short-run inelastic which, with an inelastic foreign demand for them, increases the adjustment power of depreciation. The fact that such countries are often of relatively small size and economic importance makes it unlikely that depreciation will be followed by

The estimates are for short-run instead of long-run price elasticities. (v) The estimates are for the interwar period when price variations (independent of income variations) were small. There are several reasons to expect the demand schedule for imports to be more inelastic for small than for large variations.

A. C. Harberger also takes the view that price elasticities estimated by traditional least squares methods are almost certainly too low. Cf. 'A Structural Approach to the Problem of Import Demand', *American Economic Review*, May 1953, pp. 148-59.

retaliatory action on the part of other countries. The conditions are, in short, almost ideal for the use of exchange rate changes.¹

Apart from statistical or historical evidence there are certain general considerations which suggest that the elasticities of demand of one part of the world for the goods of another are likely to be greater than .5. Firstly, there must be some difference between elasticities in the long and short run. International trade is carried on through the media of selling and forwarding agents and contacts with financial, transport, and insurance groups abroad are important. Established lines of contact and sale are not lightly broken and only price changes which are likely to be permanent will induce merchants to switch their demands to alternative products. In the long-run, however, adjustments to a price change will be made and for this reason it is probable that long-run price elasticity of demand for imports is greater than that for the short-run.

These same costs to the foreign consumer which accrue from changing his sources and channels of supply make it likely that the price elasticity of demand for imports or exports is much larger for large price changes than for small price changes. The switch of demand from one product to another may even involve money costs (for example a country may import either oil or coal for industrial fuel but to switch from one to the other involves a change of capital equipment) and only a large change in price may serve to influence the volume of demand.

Thirdly, the statistical estimates of elasticities referred to above have almost all been made during a period when international trade was subject to more or less rigid controls. What it is necessary to know is the values for the relevant elasticities in the absence of such controls. It appears reasonable that, in their absence, demand would be more sensitive to price changes.

And lastly, there is one factor which greatly reduces the force

¹ Some primary commodity producing countries, aware of the elasticity conditions governing their imports and exports, attempted to exploit them by the device of multiple exchange rates. This was the origin during the 'thirties of the multiple exchange rates so prevalent in Latin American countries today. Realising that the demand for primary products is relatively inelastic and being averse to depreciation on the further ground that it would raise the servicing cost of foreign debt obligations many countries adopted exchange control. Once the government had become a monopolist in the foreign exchange market what could be more natural than that it should be a discriminating monopolist, varying rates of exchange according to the country dealt with and the nature of the transaction involved? Rates were commonly depreciated for the purchase of certain luxury imports and for selected exports, but kept at the old level for government debt service and for essential imports.

of the elasticity condition, whatever the actual values of the elasticities may be. It is that, for simplicity, the condition is based upon the assumption of infinite elasticities of home and foreign supply. Once we remove this assumption the picture changes. For, if the elasticities of supply are low, the sum of the elasticities of demand may even be less than one and still improve the balance of trade of a depreciating country. This follows since with inelastic foreign supply even a small contraction of import demand will cause import supply prices to decline and thus reduce the foreign exchange value of imports. Similarly if the elasticity of supply of exports is low, even a small expansion of demand for exports will raise their price, and thus add to the foreign exchange value of exports. Thus the lower the elasticities of supply of imports and exports the further below unity may the sum of the demand elasticities be without making depreciation ineffective. The practical implications of this are considerable. It may be inferred that the elasticity condition will be most stringent in a condition of under-employment where supply will be elastic, but that in a condition of full employment it progressively loses force as supply becomes less and less elastic. This qualification to the condition must clearly be borne in mind and we must be cautious in applying the condition to exchange rate policy in the postwar world where full employment has been the typical state.

It remains to consider very briefly the income effects attendant upon a depreciation for, unless aggregate demand is left the same in each country after depreciation, income effects are inevitable. Thus if the depreciation succeeds in the main purpose of altering the balance of payments it will also generate secondary changes in the balance via income changes.

If we assume that the depreciation increases the balance of payments of country A (the home country) with the rest of the world W then the income effects will be to raise income in A and lower it in W. According to the value of A's marginal propensity to import the rise in A's income will tend to increase imports and this income effect increase must be set off against the decline in imports resulting from the price effect. Meanwhile in W, incomes having fallen, imports will decline and this will reduce A's exports to W,— this reduction being a set-off against the original increase in A's exports resulting from the price effect. Thus the stimulus to exports and the check to imports resulting from the depreciation will be pro-

gressively retarded by the income effects, and the final favourable result of depreciation, taking into account both price and income effects, is smaller than it would be in the absence of the latter.

A final judgement upon this problem of exchange rate variations must wait upon further facts. In the meantime we may set down what emerges from this discussion as relevant to international economic policy:

(i) Depreciation is, only under certain conditions, an effective means of countering a deficit in the balance of payments. These conditions can be generalised in the condition that demand for imports and exports of the depreciating country should be sensitive to changes in their price.¹ To the extent that variations in the supply of these goods invoke changes in their prices the force of this condition is weakened.

(ii) It is not possible to say whether these necessary conditions exist in practice but the experience of currency depreciation during the interwar period strengthens rather than weakens the case in favour of exchange rate variations.

(iii) It appears likely that in the very short period demand reaction to price (or exchange rate) variations is slight and for this reason changes in exchange rates are best if made at intervals rather than frequently.

(iv) Apart from the merits of depreciation in so far as it acts upon the terms of trade the political aspects are important. Depreciation is, in the main, more likely to be successful, the smaller is the country concerned, the less its currency is one in general use for world wide settlements, and the less its products are in direct competition in world markets with those of the great powers.

(v) Where a country has a high marginal propensity to import income effects will tend to retard the beneficial influence of depreciation unless compensating fiscal policy to hold income steady in the devaluing country is taken by that country's government.

It then appears that the case against the use of exchange rate variations is finely balanced. The indications are that periodic adjustments of exchange rates to what is deemed to be equilibrium level is a necessary part of any international adjustment process.

¹ Where it is definitely known that the relevant elasticities are significantly less than unity then a revaluation of its currency unit in an upward direction is the appropriate course for the country concerned.

As we have seen, however, the fixing of exchange rates over long periods requires that adequate reserves of international liquidity should be available and should be distributed in such a way that the main economies can maintain their exchange parities in face of short-term and seasonal fluctuations of the balance of payments. Some further consideration of the size, nature and distribution of international liquidity is called for.

III

Assuming that an equilibrium rate of exchange is such as to maintain stability in the balance of payments over a stated period, it is the function of international liquidity to settle temporary deficits within that period. The longer the period over which the exchange rate is to be stabilised the greater the amount of international liquidity which the country concerned must hold.

In the absence of international reserves a country which developed a deficit in its balance of payments would have to take immediate action to correct the deficit. Let us suppose that the deficit has been caused by a recession in a country to which country A exports. A's export industries will then suffer declining sales and unemployment, and, in the absence of compensating action by A's government, A's national income will decline and unemployment in A will rise as the multiplier effect works itself out. Balance in the external account would come only when A's income had declined and caused imports to fall far enough to bring about a new balance. Not only would this decline in income have been detrimental to A but A's fall in imports would have worsened the fall in income in the depressed country. Suppose, however, that A does not accept the fall in income, but that its government implements a compensatory programme of fiscal and monetary measures. Income in A then rises to something like its former level and imports are restored also.¹ The beneficial results are then that A has prevented transmission of the recession from abroad to her economy, and that the original recession abroad has not been aggravated by a fall in the exports of the depressed country. But by resisting the deflationary influence of her foreign balance A will not have re-

¹ Clearly this is something of an oversimplification. Any offsetting policy has its limitations. A simple increase in domestic outlay will not necessarily serve to reduce depression concentrated in export industries. Nevertheless compensatory domestic action can do much to reduce the effects of a fall in foreign demand.

moved the imbalance in her foreign accounts — rather the reverse.¹ The longer the recession abroad lasts the longer the imbalance in A's accounts will persist and the greater the volume of international liquidity which A will require. Thus, in a world of economies pledged to the pursuit of full employment and debarred from balance adjustment through income deflation, it is essential to have larger reserves than in a world where a balance of payments deficit will, through income effects, bring about equilibrium at a lower income level.²

The need for reserves is therefore greater in the present world economy of full-employment-pledged nations than it was before the war, yet we find that in fact the total reserves of countries other than the United States are now much smaller in relation to the volume of trade than before the war. Total gold and dollar holdings of such countries in mid-1951 were but 20 per cent higher than in 1937 whereas total imports of such countries were at the same time approximately two and a half times those of 1937, and imports from the United States were nearly five times as great.³ The inadequacy of existing reserves has, with the fluctuations in the foreign exchange receipts of many countries, been one of the main reasons for the widespread retention of direct controls over trade and payments.

Three aspects of international liquidity must be discussed; its nature, its size, and its distribution. First as to its nature. There are three ways in which a country may settle outstanding external debts. First, it may liquidate them by the transfer of gold, or of some universally acceptable and convertible currency to the creditor country. All countries have official reserve holdings usually under the control of the central bank.⁴ Throughout the latter part of the nineteenth century sterling served as a universally acceptable currency and side by side with gold, into which it was convertible, was an international reserve for any country holding it. Since the 1930's the dollar has rivalled sterling as a world currency, and since 1945 it has been acceptable in all countries, so that the terms 'gold

¹ In so far as the recession abroad has caused prices to decline imports to A may have been stimulated.

² Attention is sometimes drawn to the low level of the reserves held by the Bank of England in the last quarter of the nineteenth century. Since the gold standard entailed automatic domestic price (and income) adjustment it is not so surprising that these reserves should have proved sufficient.

³ Cf. *Measures for International Economic Stability*, United Nations, New York 1951, p. 32.

⁴ Those of the United Kingdom are in the Exchange Equalisation Account.

and currency reserves' and 'gold and dollar reserves' now have virtually the same meaning.

So far we have spoken of the world at large. It is possible however, that a given currency will be accepted in settlement of international obligations over only a part of the world (as is sterling throughout the Scheduled Territories of the Sterling Area) and in that case this currency serves as a reserve only for settlements with countries within the region where it is acceptable. The breakdown in multilateral trade which has occurred since World War II has thrown up a complex collection of regional clearing systems and now international reserves may be spoken of as either 'general', when they are of world wide acceptance, or 'regional'¹ when they serve to liquidate settlements only within a given region. It is a country's holding of general reserves which is important, since it serves to finance trade in any part of the world. A country which holds small general reserves and large regional reserves may be driven to trade predominantly in the region for which it holds reserves although cost advantage may indicate that it would be better to trade elsewhere. A good example occurs in the case of the United Kingdom who, because she may finance all Sterling Area trade in her own currency has virtually limitless reserves for Sterling Area trade, but whose general (i.e. gold and dollar reserves) can only be replenished through a favourable balance of payments with the Dollar Area. It is shortage of adequate general reserves which has, since the Second World War, made it impossible to restore multilateral trade, and has pulled trade into bilateral channels and regional groupings.

Secondly, as a means of international payments we have what may be called 'accumulation facilities'. These occur when a foreign country accepts payment of debts in the debtor's currency, allowing the proceeds to accumulate in the debtor's country as bank deposits or short-term assets. This form of settlement is limited by the extent to which foreign countries are prepared to accumulate the currency of the debtor country. An example of such facilities is the so-called 'sterling balances' accumulated by certain countries for the supply of war materials and services during World War II. Such 'accumulation facilities' may be liquidated in various ways. They may ultimately be used by the holder to buy goods or services in the country whose currency he has accumulated, or in

¹ Sterling balances and EPU quotas are examples of regional reserves.

another country, by that country making the facilities convertible into another currency or into all currencies. Alternatively the accumulation facilities may become permanent funded debts held in the debtor's country by the creditors.

And thirdly, international debts may be settled by drawing rights upon foreign currencies. These may be foreign loans which extend credit to the debtor nations as a bank overdraft does to an individual, examples being the various lines of credit extended to the United Kingdom after the war by the United States and Canada; or they may be outright gifts such as those made by the United States under the European Recovery Programme.

Finally, we must include in this category drawing rights upon the International Monetary Fund which is in essence nothing more than a pool of currencies to provide additional drawing rights for member nations and thus augment the world stock of international liquidity.

The total stock of international liquidity which the government or monetary authority of a country holds and controls is important, since it represents the resources whereby the existing exchange rate is maintained. In this connection it is essential to distinguish between reserves which a country must hold for the purpose of dealing with balance of payments fluctuations, and reserves which a country may use for the purpose of financing a sustained import surplus attendant upon capital development in its own territory. Although we are at present concerned with the former it is often difficult in practice to distinguish between reserves relative to these two uses. A country with reserves adequate to the financing of short period fluctuations in its foreign balance may find such reserves inadequate to meet an import surplus of long duration such as results from a development or reconstruction programme. Such is not the purpose of liquid reserves. Capital programmes of this sort involving an import surplus should be financed by long-term foreign borrowing. Liquid reserves should be for current account discrepancies only.¹

Bearing this in mind we can say that the size of the aggregate

¹ This point is stressed because of the fact that following the war many devastated countries were faced with severe deficits in their balances of payments while at the same time standing in need of large capital re-equipment. The distinction between international liquidity for current needs and for capital investment here became blurred. It was the decision of the Bretton Woods Conference that the IMF should provide international liquidity for current transactions while the IBRD provided loans for capital investment.

global reserves of international liquidity necessary for the satisfactory operation of world payments is dependent on three factors. Firstly, the policy of the leading economies with regard to exchange rates is important. A régime of fixed exchange rates, even at equilibrium levels, will require a larger world stock of international liquidity than when rates are allowed to fluctuate freely and short-term deficits are met by depreciation rather than by reserve transfers. The greatest volume of international liquidity is necessary when it is desired to stabilise the parities of the leading currencies for a long period of time, as, for example, over a five to ten year period.

Secondly, the optimum level of reserves depends upon the policies which each of the leading economies is pursuing with regard to the control of their levels of income and employment. As we have seen, a fully-employed world, from which deflation is precluded as a means of foreign balance adjustment, is one in which deficits must be met by drawings upon reserves. Nor can we suppose that deficits will not occur in such a world. Apart from disequilibria springing from structural changes in trade or fortuitous and transient influences such as crop failures, deficits and surpluses may spring from income differentials even at or near full employment. For example, country A may be content to maintain a level of full employment adjusted to a datum of an allowable five per cent of unemployment while countries B, C and D aim at three per cent. Country A will then, *ceteris paribus*, have a surplus in its balance of payments relative to countries B, C and D,¹ and until corrective measures can be taken B, C and D will have to provide liquidity to finance their deficits with A, either from surpluses with other countries X, Y and Z, or from their national reserves. As long as deflation as a means of balance adjustment is forsworn by the great economies they must be prepared for recurrent calls upon national currency reserves and must accumulate reserves large enough to meet these.

Thirdly, the size of international reserve holdings is conditioned by whether trade is multilateral or is in some way restricted, as for example by bilateral trade and payments arrangements. As long as

¹ If further proof of this point is required it is furnished by the history of the years since 1945. In Britain and the United States the employment rate has been maintained at a high level but relative movements of the two national incomes, even within a narrow range, have been productive of balance of payments fluctuations of a considerable character.

a condition of fully convertible currencies exists, the mechanism of the exchange market makes it possible to hold a single national reserve of gold and currencies capable of liquidating liabilities in any country; but where currencies are not convertible a country must hold a reserve of the currency of every country (or group of countries) with which it trades and with whom it may incur a deficit.

To sum up then, the volume of international monetary reserves determines the degree of imbalance (as to magnitude and duration) which the world monetary system can bear in the absence of adjustment by depreciations or relative income changes. In a world where full employment is universally desired side by side with stable exchange rates the role of international liquidity becomes all important. If the supply is inadequate those countries in which the inadequacy occurs, loth to abandon the employment and exchange stability aims, fall back upon direct control of trade and payments as the only remaining alternative.

Clearly, however, there is no reason why the total volume of international liquidity should not be augmented by international action. An international body can by agreement create amounts of such liquidity, which, providing it is universally acceptable, may be used by countries for the liquidation of deficits in their balances of payments. In so far as international liquidity is thus created by an international organisation its distribution can also be controlled, according to the allotments made by the organisation to each country.

The world total of international liquidity should ideally be distributed among countries in relation to their needs — need being measured by the degree of fluctuation to which a country's balance of payments is subject, as well as by the volume of its trade. The degree of price and demand fluctuation to which a country's imports and exports is subject should be considered. Primary commodity producing countries, which in the interwar period showed wide variations in their balances of payments, should in some cases hold reserves which, relative to the volume of their trade, are larger than those of industrial countries.

The existing distribution is far from ideal. It is the result of a long process of economic development. Countries have accumulated reserves in the past as a result of the objective need for reserves as dictated by their balances of payments; in obedience to

- motives of national security and stability; and in accordance with the wealth of the country. A country's national income, consuming habits, economic policy and many individual characteristics help to determine what is, for it, a normal holding of international liquidity, but the distribution of liquidity as determined by such factors is not necessarily the same as that which is appropriate to an efficient international payments system. The United States at present holds by far the largest gold reserve in the world but as a country whose balance of payments is in every respect favourable it has least need of such reserves.¹ As Nurkse points out² the underlying inequalities in the distribution of wealth are such as may 'distort or even wreck any system of international currency reserves aiming at generally stable and free exchanges'.

IV

It is the purpose of economic theory to furnish the policy maker with an account of the basic conditions under which he must work, of the way in which the economic system functions and of the probable implications of this or that course of action. No serious effort to influence the course of economic events can be made without this knowledge and an inexorable fate attends those who would ignore its precepts. But those who claim more for theory do it no service. The conditions of the simplified economic model are rarely exactly reproduced in the real world and the conclusions which appear clear-cut and precise in the closing pages of the textbook must inevitably decline into generalities and working hypotheses in the office and the conference room. Moreover, the assumptions upon which much of our theorising is inevitably based stand in need of close scrutiny and constant review. The part which factual study and empirical testing of economic hypotheses must play can hardly be overestimated.

In the field of international economic policy abstract analysis has its part to play, and, subject to the above limitations it is an important part. But in the study of the international economic relationships of sovereign states a host of non-economic factors

¹ The United States at present holds more than half of the total monetary gold stock of the western world. At \$21.8 milliard its holdings are equal in value to almost two years' merchandise imports. For an excellent analysis of the present distribution of world monetary reserves see Annual Report of BIS for 1956, pp. 154-65.

² *Op. cit.*, p. 24.

exists which must condition policy decisions as much as the economic and, for this reason alone, it is arguable that theory can provide us only with an account of the conditions under which we operate. There is no question of our constructing a body of theory so complete and all-embracing as to apply it to this or that problem and obtain a clear-cut solution. Moreover, in international economics our factual data have grown slowly. We are still testing warily the assumptions on which we have built and important policy directives stemming from theory must hang upon the results of empirical investigations. It might be profitable to conclude this brief theoretical interlude by setting out some of the basic problems which have emerged from our discussion and which have a relevance to the practical problems which await us in subsequent chapters.

The first, and most challenging, problem which is posed is that of the conflict between the policy aims (which appear to be mutually exclusive) of domestic price and income stability at full employment and the stability of the balance of payments. This is not a new problem. It existed under the gold standard¹ and its existence in a practical and political sense was recognised at least as long ago as 1918. The failure of the gold standard during the interwar years and the domestic deflation and unemployment with which (particularly in Britain and Germany) the later 'twenties and early 'thirties are associated brought forward full employment and domestic price stability as the main aim of economic policy. There was from 1931 onwards tacit acceptance of the doctrine that these should not be sacrificed on the altar of a stable exchange rate, and in the interests of external advantages which to many seemed hypothetical. The problem as it appeared in the 'thirties was, however, more apparent than real. Only when in the post-1945 period the economic tides which had for so long ebbed towards general deflation turned and driven by impelling need for reconstruction, development and deferred consumption surged in the opposite

¹ The pure theory of the gold standard would have admitted no such conflict. Although an adverse balance of payments set forces in train which led to deflation of domestic prices and costs, such deflation was not in itself undesirable and, under classical assumptions of perfect markets and factor mobility, did not lead to under-employment. In fact, however, a rise in unemployment was inseparable from this process of domestic deflation and when this came to be recognised (as it did forcibly in the early 'twenties) the problem of domestic stability of prices, costs and employment versus stability of the external value of the currency was seen to be a fundamental one.

direction and when the development of income analysis and new fiscal techniques made full and stable employment a normal and attainable policy aim, did the full significance of this basic conflict appear. Since the Second World War the great economies have maintained high levels of employment and it is a reasonable assumption that they will continue to do so. What is certain is that none of the great economies will deliberately sacrifice its claim to full employment in the interests of equilibrium in the balance of payments. All experience so far points in the other direction—that, as long as reserves last or credit can be obtained, countries will push their income and employment levels to the border of inflation regardless of the consequences.¹ Not only has this led to recurrent disequilibrium in foreign balances but to a prolongation of those controls on foreign exchange payments and on imports which were imposed during the war and a proliferation of new ones which have been imposed since. We are now faced with the basic problem of evolving a payments system for a world in which one of the former variables, that of income and prices in individual countries, is removed.

This leads on to the second factor with which we are confronted—stable exchange rates. In the absence of changes in domestic prices and costs classical theory would have us turn to the exchange rate, through whose variations equilibrium in the balance of payments would be restored. Yet free exchange rates, like free income levels, have been sadly out of fashion. Theory has questioned the efficacy of exchange variations to improve the balance of payments and on the ineffectiveness of short-period fluctuations in the rate there is little difference of opinion. Only in the long period does demand for imports and exports react to changes in the rate and then only under certain conditions. Moreover, the disturbing effect of frequent alterations of the exchange rate upon international trade is argued both from theory and experience and stable rates, changed only to meet changes in basic international conditions, seems to be the condition upon which much of the informed

¹ The political motive here is important. The democratic governments of the western countries are bound to full employment policies by the demands of an electorate to whom unemployment is still a grim memory from the 'thirties. To argue the terrors of an adverse balance of payments is politically difficult inasmuch as the direst effects are largely unknown and unexperienced. In the choice between stable prices and under-employment on the one hand and full employment and creeping inflation on the other, European electorates have cast their votes unswervingly for the latter.

economic world has set its heart. But herein lies a problem, for if incomes are not to vary and exchange rates are to be stable, then both of the variables through which the international payments system has hitherto adjusted itself are removed. How then is it to function at all? The obvious answer is that it can only do so if two things happen: if, about the level of full employment income some margin of adjustment is allowed by government; and if there exists in the hands of national monetary authorities large stocks of international liquidity to serve as transfer settlements until balance adjustment is attained by some other means. If the above conditions of stable incomes and stable rates of exchange must now be accepted as part of the international economic environment then we require a much larger and appropriately distributed stock of international liquidity than we have had hitherto. In the absence of this it is inevitable that nations will seek to solve their balance of payments problems by methods of direct control and the already formidable thicket of controls and restrictions may become permanent and impenetrable.

The existence of controls, restrictions, and discriminatory practices in international trade is the last feature upon which we would focus attention, for it is perhaps the most important feature of the contemporary scene. In part, direct controls over payments are the result of the War and its aftermath but in part they spring also from the increasing measure of government control and interference with the economy. They had their inception in Central Europe after the fall of the gold standard, were pioneered in the Germany of Schacht and perfected in the Britain of the war years. Since the war they have increased in number, form and scope under the influences of recurring monetary crises. We may see these controls, as the planners at Bretton Woods saw them, as marking a phase and as something which could be discarded as the shadow of the war passed away. Or we may regard them as a logical outcome of the breakdown of the older payments system. Certainly there is little in the history of the last ten years to encourage the belief that the breakdown of free multilateral trade is transitory. The IMF and GATT have made little progress with their programmes for the removal of restrictions and the reduction of tariffs and each developing crisis in the foreign balances of the great economies has been countered by fresh stop-gap measures. Perhaps the time has come when we must seek an answer to the

question: should plans for international monetary co-operation be based on an attempt to rehabilitate the old multilateral payments system, as were those at Bretton Woods, or should they admit to a change so fundamental in the international economy as to demand that co-operation should seek not the end of controls, but principles of international conduct in accordance with which they may be applied?

Whatever conclusions may be reached on this problem must wait upon the judgements which are formed by the examination of the experiments made in international monetary co-operation since the war. In 1944 the problem posed itself differently and for better or worse the plans which were laid at Bretton Woods and elsewhere were based upon the assumption that the pre-war payments system should be the basis of further planning and that the controls of the war years should progressively be dismantled. From the Tri-Partite Monetary Agreement of 1936 with its principle of exchange rate management the logical next step lay towards an international organisation with specified powers and influence over member nations.

In the light of the theoretical discussion above, the need for international monetary co-operation should be evident and it might be helpful at this stage to set down tentatively the aims which should motivate such co-operation. These should be:

(i) To augment the international liquidity at present held in the reserves of individual states;

(ii) To resolve the conflict between domestic and international stability;

(iii) To co-ordinate exchange rate policy; and

(iv) To hold a watching brief over controls imposed upon international payments.

CHAPTER 4

THE SYSTEMS OF ADJUSTMENT

I

IN considering the alternative methods of international adjustment which are available it is well to start with one obvious fact; the equilibrium exchange rate for a country's currency is a reflection of its domestic price level. If this may be taken for granted then it follows at once that the pattern of exchange rates ruling in the international economy under equilibrium is a reflection of the various domestic price levels of the participant countries. Since there are only four possible cases for the description of the behaviour of national price levels, then it follows that this limits the possible number of exchange rate conditions. These possibilities we may set out as follows.¹

Domestic price levels may

- | | | | |
|--|--|--|-------------------------------------|
| (1) Move independently in every country. | (2) Move in unison, both as to direction and in proportional rate of change. | (3) Move in some countries, remain stable in others. | (4) Remain stable in all countries. |
|--|--|--|-------------------------------------|

and to each case the appropriate exchange rate condition is —

- | | | | |
|--|------------------|--|------------------|
| (1) Proportionately fluctuating rates. | (2) Fixed rates. | (3) Proportionately fluctuating rates. | (4) Fixed rates. |
|--|------------------|--|------------------|

Thus it follows that if we desire a world of fixed exchange rates we must establish and preserve the conditions where national price

¹ This formulation is borrowed from F. D. Graham's *Fundamentals of International Monetary Policy*. Essays in International Finance No. 2, Princeton 1943, p. 7.

levels remain stable or where their movements are similar both as to direction and amplitude. If we choose to allow price levels to move freely relative to one another then we must accept the consequence of allowing exchange rates to vary in order to reflect these movements. Or alternatively if we want stable exchange rates we must pursue policies to order national price levels accordingly and any adjustment to foreign balances must come through planned changes in national price levels; if we cannot accept such regulation of national price levels then the only alternative is that adjustment be made through exchange rate variations. But, even if we choose the latter option, we are left with an element of choice as to what degree of rate variations we will tolerate. Will it be a day to day variation in which the rate is left, shorn of all control, to shiver in the winds of supply and demand for the currency; or will it be a time-to-time variation in which the rate is held stable in the short period (by compensatory financing) and adjusted only in obedience to what are construed to be fundamental influences?

Clearly, then, a threefold choice as to adjustment mechanisms lies before the world economy: fixed rates of exchange with adjustment through domestic price and income changes, as under the gold standard; free and fluctuating rates of exchange, the condition which obtained from 1918 to 1925, and, with modification, from 1931 to 1939; and the condition (which we shall call 'managed flexibility') in which exchange rates are varied only at long intervals according to the decision of monetary authorities — the condition which has obtained since 1945. These three possible systems have obtained in the international economy in the historical order in which we have set them down. To them we must add a fourth — the method of direct control of transactions in foreign currency. We can no longer refuse to recognise the existence of this method nor can we regard it as a feature of abnormal conditions. Whether we like it or not, it has been the dominant feature of balance of payments adjustment since 1945 and the typical reaction of a country faced with an external deficit has been to impose additional controls upon imports or foreign exchange. It may be that the choice of methods which this chapter postulates has already been made in favour of this the fourth alternative. Be that as it may we must consider its characteristics and place them beside the alternatives which were the solutions of a more liberal age. As any discussion of the planning of an efficient international monetary system must take

account of these four alternatives we shall in this chapter consider each of them in turn. But while it is our task to compare these systems as processes of balance of payments adjustment, it is necessary to remember that they have important aspects apart from this. They may each have influences upon total world income and upon its distribution which are far-reaching. All have non-economic and political implications. The examination of these more general aspects we must put aside as they would provide material for a book in themselves. We may, however, draw attention to some of the more important general aspects as we proceed.

II

Changes in domestic prices and income have an adjustment effect upon the balance of payments. This is true whether we base our thinking upon classical theories of adjustment or upon the more recent theories of the foreign trade multiplier. As has been shown¹ both theories envisage a more or less automatic process for the restoration of equilibrium, differing only in the causal factors — price changes and income changes — which they stress. For this reason, and since adjustment via price variation is a system of which the world has experience, we are probably better informed upon this than upon any of the alternative methods of adjustment. Whether we view the process as one of price or of income variation its practical implications are the same; it implies the use of an expansionary monetary and/or fiscal policy in the surplus country, a contractionary policy in the deficit country; it implies the subjugation of domestic stability to the dictates of the foreign balance. This fact, combined with a justifiable suspicion of the reinstatement of any system which resembles the gold standard militates against the use under modern conditions of price or income adjustments. Yet if we decide completely against the use of price and income variations we are limiting the alternatives and may be forcing upon ourselves methods of dealing with balance of payments fluctuations which preclude the main advantages of international trade and specialisation. Before denying ourselves the use of this method it is wise to consider whether it is attended by such dire consequences as is so often assumed.

It is possible to say at the outset that the reinstatement of the gold standard is out of the question. Whatever may have been its

¹ Cf. chap. 2, p. 45 above.

qualities as a system of international adjustment, it must be recognised that the failure of the standard in the interwar period, the monetary chaos and disorder with which, rightly or wrongly, its name is now linked, and the indelible impression which it has left upon the minds of financial statesmen, all militate heavily against its future use.¹ In the choice between international management and loyalty to a world system on the one hand and national economic autonomy on the other, nations have chosen in favour of the latter.

Yet while precluding the gold standard and admitting, under present circumstances, the inevitable precedence of domestic stability and full employment, it is possible to envisage price and income variations as playing some role in adjusting balances of payments in the future. In order that we may form some opinion of the aversion of governments to such a proposal it is as well to examine briefly the implications of price and income variations.

Three arguments may be used against price and income adjustment. Firstly, domestic prices and incomes are, under modern conditions highly inflexible. Any attempt to reduce them by fiscal or monetary methods would result in distortions, in price reductions in some sectors of the economy and in unemployment in others. The desired smooth series of price effects, resulting in adjustment of the foreign balance, which classical theory envisaged would in fact be replaced by a clumsy mass reduction of demand for foreign goods through a fall in real incomes. Secondly, it is alleged that the frequency with which adjustments to the foreign balance are required is such as would render price and income adjustments intolerable and a constant threat to the stability of the economy. And thirdly, the close scrutiny under which the economic policies of democratic governments are conducted makes any divergence from the narrow path of full employment politically impossible even if it were economically desirable. In the light of these arguments it is clear that primary reliance on changes in domestic prices and incomes is undesirable.

All this is not to say that such changes may not play a secondary

¹ We have not considered it necessary to embark here upon a full scale discussion of the international gold standard. Those who wish for a more detailed discussion of the gold standard must turn to the many excellent books which deal with it, e.g., R. G. Hawtrey, *The Gold Standard in Theory and Practice* (Fifth Edition) London 1947; W. A. Brown, *The International Gold Standard Reinterpreted 1914-34*, 2 vols, New York 1940; J. M. Keynes, *A Treatise on Money*, vol. II, chap. 35, London 1930.

role in adjustment. If, about the full employment level of income, some margin of variation is allowed by governments two useful contributions to adjustment can be made: first, the species of short-term imbalance which has been so prevalent since 1945, and which has been caused by domestic demand inflation spilling over in excess demand for imports and external deficit, can be prevented; and secondly, the influence of another medium of adjustment, the exchange rate, may be reinforced, fiscal and monetary checks being administered when a depreciating exchange rate reflects a worsening foreign balance. We are too prone to assume that only major deflations of unpleasant dimensions will serve the purpose of adjustment. It is probable (and monetary history since 1945 supports the view) that in a world of fully employed economies quite minor curtailments of expansion will suffice to restore balance. Our views on this matter have been too much conditioned by inter-war period deflations carried out from a starting point of 12 per cent unemployment. To allow of adjustments between 2 and 5 per cent might bring considerable flexibility into the world economy without sacrificing the high levels of real income and employment upon which governments and people have set their hearts.

III

The merit of flexible exchanges as a vehicle of adjustment is more difficult to assess than that of relative changes in prices and incomes. The arguments of antagonists and protagonists are more evenly balanced, the record less instructive, the advantages alluring yet hypothetical. We can but marshal the arguments *pro* and *con* tempering our reaction by whatever teaching experience has to offer.

An obvious merit of free rate adjustment is its simplicity. Based on the unassailable fact that, as in every market, there must be some equilibrium price which equates supply and demand, so in the market for foreign exchange there must be some rate at which demand for and supply of the home currency will balance.¹ Then too, of all the variables the exchange rate is the easiest to alter. How much simpler to allow the rate to depreciate by, say, 5 per

¹ 'Scarcity of a given currency can only exist when its price (i.e., the exchange rate) is kept artificially low. There is in any market a price at which demand and supply are equal'. Cf. F. D. Graham: *The Cause and Cure of Dollar Shortage*, Essays in International Finance, Princeton, No. 10, January 1949.

cent in terms of another currency, than to reduce prices and costs in the home country by 5 per cent relative to those of the other country. Moreover, a free rate system is independent of the banking system which is then free to operate in the interests of domestic price stability. It does not require the complementary use of monetary policy (as did the gold standard) but is compatible with modern techniques of fiscal and budgetary policy. It does, however, require the organisation of an effective market in forward exchanges in order that the uncertainty engendered for foreign trade operators by short term fluctuations may be eliminated.

The second argument in favour of the flexible rate system is a powerful one. Adjustment to the balance of payments must be effected through movements, either in the exchange rate or in the prices and income of the adjusting country or by direct control of transactions in foreign exchange. Since, in the modern world of full-employment-seeking economies, adjustment through income deflation or inflation is denied us — we are driven back upon exchange rate changes and direct controls as the alternatives.¹ If we refuse to accept the first of these then it is certain that direct control of foreign trade will be widely practised and will indeed become a major technique of adjustment. This is, of course, what has happened since World War II. The co-existence of policies of full employment with fear of the possible results of flexible rates of exchange has produced the thicket of controls which international organisations have been powerless to remove. As long as the nature of this choice of adjustment methods is not understood these controls will continue. Even should they be removed in a period of easement, they would, with the existing condition of inflexible incomes and inflexible exchanges rates, be reimposed at the first sign of renewed imbalance. In this sense, then, variation of the exchange rate is the appropriate method of adjustment for a full employment world. This alone is a powerful argument in its favour and gives it high claim to our consideration. Certainly it is true to say that it is impossible to operate a satisfactory system of international equilibrium in the absence of a satisfactory system of

¹ Not all economists take this view. Sir Hubert Henderson argued (cf. 'The Function of Exchange Rates', *Oxford Economic Papers*, vol. 1, no. 1) that since the exchange rate is the one variable which is firmly within our grasp it is better to control that and adjust income and prices accordingly. The writer's view is that this alternative does not exist in view of the determination of the great powers to stabilise employment at a high level. This is not a value judgement but a recognition of facts.

exchange rates. Whether satisfaction is best obtained by allowing exchange rates to vary freely and find their own level or by periodic adjustments is, however, quite another matter.

The case against flexible rates is a fivefold one. Firstly, we must recur to the so-called elasticity condition which necessarily applies to the power of any exchange rate change to adjust the trade balance. Even in the absence of reliable data on the magnitude of import-demand elasticities it is fairly certain that the foreign trade structure of some countries is less amenable to exchange rate adjustment than others. Take the case of a manufacturing country, importing food and raw materials, and exporting finished products sold in competitive world markets. If a deficit occurs in the foreign balance of such a country then a large measure of exchange depreciation may be required to make the necessary correction. As the rate depreciates exports cheapen to the foreign buyer, imports rise in price to the domestic buyer. Although export demand may be stimulated by the fall in export prices, it is likely that this will be more than offset by the rising import bill. If this is the case the foreign deficit will worsen and the rate depreciate still further. This is, in fact, the case of unstable equilibrium which we noted above.¹ In theory the depreciation might continue until, at some stage, the demand for exports becomes elastic, the import demand falls and the balance is adjusted. What is, however, more likely is that the country will continue, with a worsening balance of payments, to import its vital food and raw materials as long as foreign credit and the tolerance of its suppliers permit. Ultimately it may be forced to limit its imports directly at the cost of unemployment and a reduced standard of consumption. Thus the elasticity condition raises an immediate and serious qualification to the apparent simplicity of free rate adjustment. Only in the case of countries the elasticity of demand for whose imports and exports is significantly greater than unity is full adjustment through depreciation possible without destabilising domestic effects.² There is also a more general difficulty connected with the elasticity condition. It is

¹ That is when the sum of the elasticities of demand for imports and exports is less than one. Cf. p. 64.

² It is fairly clear that the United Kingdom is a country for whom balance adjustment through depreciation may be destabilising in view of the inelastic demand for British imports. The necessity to maintain raw material supplies in the interests of full employment might, with a sharp depreciation, generate cost-inflation which would serve to nullify the stimulus to export sales brought about by the depreciation.

likely that the demand for both the imports and exports of any country will in the short run be relatively inelastic. Only for considerable rate changes which the commercial world deems likely to be of long duration will customary trade links be severed and demand switched from one country to another. For this reason the depreciation which in any given case serves to influence the trade balance must be considerable and the process of adjustment is likely to be a longer one than at first appears.

Secondly, it is argued that rates of exchange which are free to vary from day to day have a deterrent effect upon buyers and sellers engaged in international trade. The risk of loss of profit through a change in the price they must pay or will receive for foreign currency may cause dealers to trade at home rather than in foreign markets. The additional trouble which is involved in selling abroad rather than at home is, it is argued, always considerable and to add an additional risk is to heap Pelion upon Ossa. To this there are at least three answers. Firstly, it must not be assumed that flexible rates are necessarily unstable. Under modern conditions of stabilisation funds the day to day variations are likely to be slight and a negligible risk. Secondly, the exporter is just as likely to gain as to lose by a rate variation; and thirdly, where a well-organised forward exchange market exists the risk may be avoided altogether,¹ since exporters can obtain a prior assurance of a guaranteed price for the foreign exchange which they will later have at their disposal. All in all it seems that the deterrent effect of flexible rates upon ordinary day-to-day import and export trade would be inconsiderable.

The third objection to flexible rates is more problematic. It is alleged that frequent variations in the value of a currency will serve to curtail international investment: the lack of any fixed monetary relationship upon which international borrowing and lending contracts may be based may serve to deter borrowers and lenders from concluding such contracts. The prospect of a constantly fluctuating money value of a loan may certainly be discouraging to a would-be borrower, still more so the possibility of a varying burden for servicing and repayments. Although the lender may be protected from loss by his insisting that the loan must be repaid and serviced in his own currency, there remains a risk for the borrower, but it is hard to believe that it will be sufficient to deter any save marginal

¹ Although it must be remembered that the coverage afforded by forward exchange transactions involves additional cost.

borrowers from accepting loans. It is indeed arguable that borrowers and lenders are much more sensitive to price level prospects in their two countries than they are to changes in the exchange rate and that constancy in the real domestic value of currencies is the true basis for international investment. Moreover, unless exchange rates are to be held stable in perpetuity (as under a gold standard) the effect of uncertainty as to future rates of exchange on long-term lending will exist equally whether rates vary from day to day or are adjusted at long intervals to meet changing conditions. Where loans are made for periods of five years or upward the element of uncertainty will hardly be greater in one case than the other. Uncertainty as to prospective rates of exchange would certainly have the effect of diminishing the volume of short-term lending, which is dependent upon narrow interest rate differentials and cannot sustain even small exchange risks. But short-term funds movements no longer play the role which was theirs during the interwar period and it is relatively certain that in future (as at present) they will be subject to direct control and limitation. The effect of flexible rates upon them is not therefore important.

The fourth danger to which a flexible rate system might be subject lies in the possibility of competitive depreciation. In the absence of any international co-ordinating authority or agreed formula of foreign exchange manipulation the system might lapse into anarchy as countries sought, through currency depreciation to wrest markets from rivals. Such was the condition in the international economy between 1931 and 1936 before the Tri-Partite Monetary Agreement established principles for exchange management and for the working of stabilisation funds. But in the present age of full employment and near-inflation competitive depreciation is much less likely to occur than it was during the 'thirties. Countries are less eager to seize export markets than to import cheaply and in quantity in order to ease the inflationary pressure in their economies, and this is accentuated by the great rise in primary commodity prices which has taken place since World War II. This might indicate the possibility of competitive appreciation but this seems unlikely for shortages of gold and foreign exchange reserves in most European countries preclude deliberate attempts to force up currency values in order to improve the terms of trade. In present circumstances there is little cause for anxiety that competitive currency manipulation (either upward or downward) will prove a

problem. Moreover it is not over-optimistic to assume that any flexible rate system which might be established in future would not be entirely free but be under the aegis of an international organisation or be governed by specified working principles through which this danger might be avoided.

The last argument against the establishment of a free rate system is, perhaps, somewhat hypothetical, for it has to do with conditions of which we have, as yet, no experience — the use of such a system under conditions of full employment in the member countries. We have already shown that in some respects a free rate system is suited to a condition of full employment. What follows must be regarded as a qualification to this.

Let us suppose that, under a condition of free exchanges, an economy which enjoys full employment develops a deficit in its balance of payments. Let us suppose also that this country imports a large amount of its food and raw materials. As a result of the deficit its exchange rate depreciates causing the price of its imports to rise. Now under the postulated conditions the demand for these imports is likely to be inelastic and they will continue to be imported even at the higher price. The increase in raw material costs will quickly drive the domestic price level upwards. Wages will ultimately rise under the influence of higher food prices and general cost-inflation will result. When the country concerned is already fully employed the effect of such cost-inflation may be serious. The rise in prices may have the effect of causing demand for exports to fall so that the foreign balance deteriorates further, and the exchange rate depreciates still more. In this way a spiral of depreciation, cost-inflation, balance deterioration, and further depreciation may be generated. With the economy already at full employment the inflationary pressure upon the domestic price-level is considerable and immediate and, unless remedial steps are taken, the inflationary pressure may have serious consequences.¹ Moreover, the conditions postulated are of sufficiently wide application to cause fear that in an extreme case of imbalance in one or more of the great economies the adjustment system of flexible rates might break down altogether. Certainly there is little doubt that in Britain between 1945 and 1952 a free rate for sterling would have

¹ One can speculate what might have been the impact upon Britain of the primary commodity inflation of 1951 if the sterling rate had been free to depreciate and a spiral of this sort had been generated.

done little to correct the country's external disequilibrium, but would probably have increased the amount of domestic inflation and could not have been tolerated.¹

The sensitivity of the international economy under conditions of full employment is great. Where each country exists in a condition bordering upon inflation small variations of income often have considerable foreign balance repercussions. If to this were added in deficit countries the additional inflationary thrust of cost-inflation due to depreciation the result might be an intolerable instability in the world economy. There are enough destabilising forces emanating from income variations even when exchange rates are steady. We must ask ourselves whether it is wise to invoke the price system as a further source of instability.

The 'cost inflation' argument is a powerful one. It has led one writer to assert that full employment and flexible exchange rates are incompatible,² and others to argue that full employment should not be the main aim of national economic policy, which should rather be directed towards the maintenance of a stable external value of currency and protection of foreign currency reserves. To hold either view is to submit to panic. There is no reason to suppose that a way cannot be found of operating a flexible rate system side by side with full employment — a system which, while relying on exchange depreciation as the method of foreign balance adjustment would ensure that depreciation proceeded neither so fast nor so far as to cause the dire consequences which are threatened.³ It would be possible for countries to define a range over which their exchange rate might vary, but beyond which any depreciation would be checked by the use of foreign exchange reserves. Simultaneously domestic policies of disinflation (as distinct from deflation) could be pursued to nullify the inflationary effects of the depreciation. So long as depreciation is not allowed to operate in a purely automatic fashion there should be little danger of the above conditions developing. Nor is there any likeli-

¹ It was for a time fashionable among certain writers, particularly in the United States, to argue that Britain's foreign balance problem might be solved through less favourable terms of trade. How suitable terms of trade were to be obtained was not made clear. If by a depreciation of sterling then depreciation would need to have been carried to impossible lengths; if by a domestic deflation then it is evident that for no British government was this a possible policy.

² Cf. Sir Hubert Henderson, 'The Function of Exchange Rates', *Oxford Economic Papers*, (New Series) vol. 1, no. 1.

³ Cf. Chap. 7, p. 195 below for a description of a free-rate system which the writer believes to be suited to present circumstances.

hood that governments will in future bind themselves to the working of automatic systems. The difficulty will be rather to ensure that general principles and standards of conduct will be honoured. This is not an age in which international systems can afford the luxuries of automatism or inflexibility.

The case for free exchange rates is finely balanced.¹ No system of international equilibrium can be perfect and the best that we can do is to decide wherein the balance of advantage lies. If we are driven to reject adjustment by domestic income variation then we must accept the only alternative, exchange variation. The difficulty in such an acceptance is that for several decades economists have been telling us just what are the defects of such a method, neglecting to point out (and in some cases to realise) that it is the sole alternative to their *bête noire* — fixed exchange rates and the gold standard. Our discussion has listed four minor dangers of the system and one which is more serious. It remains to be seen whether a system can be devised which minimises these.

IV

We come now to the third alternative system of international adjustment — the method whereby national governments endeavour to stabilise their national incomes at full employment levels, seeking foreign balance adjustment through changes in exchange rates which are made, not continuously in accordance with the movements of a free exchange market, but from time to time as the need arises. This system is sometimes referred to as 'managed flexibility' or the method of the 'adjustable peg'. From an institutional standpoint it may be achieved by country A defining the value of its currency unit in terms of gold, and if countries B, C, and D do likewise then indirectly the exchange rates between all four currencies are also determined. The parity of a currency with gold may be defined at a single level, which gives a single value for the exchange rate, or different buying and selling prices for gold in terms of currency may be declared, thus giving the exchange rate

¹ As Sir Donald MacDougall says, "There are clearly arguments on both sides. There is no absolute truth in this matter." Cf. 'Flexible Exchange Rates', *Westminster Bank Review*, August 1954. A good case for flexible rates has been made by Milton Friedman, cf. *Essays in Positive Economics*, p. 157; the case against them has been well put by Sir Lionel Robbins, cf. *The Economist in the Twentieth Century*, London 1954, chap. 5.

a range of fluctuation commensurate with the spread between the two prices. When the monetary authority in any country wishes to alter its exchange rate it has only to alter the parity of its currency unit with gold. Thus if A lowers the price of gold by 30 per cent in terms of its own currency it thereby appreciates its exchange by 43 per cent in terms of every other currency whose gold price remains unaltered. Thus, under conditions of managed flexibility the change of rate is made on the decision of the monetary authority, is a deliberate policy to achieve adjustment, and is of such magnitude as will, in their judgement, serve to restore equilibrium. With this system there are no short-term fluctuations of rate and for purposes of day-to-day business the rate may be taken as fixed and given.

Now clearly the system of managed flexibility resembles the method of free rates. Both envisage disequilibria in the external balance as correctable by exchange alterations, both reject the method of domestic income adjustment and allow domestic policies for high and stable employment, and both are subject to the same condition (i.e., the condition of elasticity of demand for imports and exports) if they are to be effective. But the adjustable peg system carries additional consequences and the choice between it and the system of varying rates is significant. For that reason it requires separate attention. Further it is the system of equilibrium adjustment whose theory underlies the working of the present world system under the IMF.

The system is of course a mixed one. While recognising the merits of stable rates of exchange it rejects the gold standard with its corollary of domestic income adjustment, and seeks to use the exchange rate for adjustment purposes, but without incurring the disadvantages which attach to freely varying rates. For this reason one is at first tempted to the view that the present bias in favour of a mixed system springs from the fact that neither of the pure unmanaged systems has been successful in operation. Perhaps, looking back over the past quarter of a century it seems that we were first driven in the 'thirties to claim the right of national control of domestic income and the employment level, thereby ending the gold standard. Then, after nearly a decade of competitive depreciation, we found we had no stomach for free rates and the compromise of managed flexibility followed.

The system is not without some theoretical backing. If, as is

generally agreed, import and export demand is only sensitive to price changes in the fairly long run, why accept the disadvantages of continuously fluctuating exchange rates? Is it not preferable to meet short-run movements in the balance of payments by drawing upon national exchange reserves and changing the rate only in obedience to changes in the long-run equilibrium position? If the ruling rate of exchange is an equilibrium one then, in the long run,¹ the distribution of the existing stock of international liquidity will not be altered. This however, and the fact that some of the irritant effects of free rates are avoided, seems to exhaust the case for the defence of the adjustable peg system. The case for the prosecution is more lengthy.

The most obvious difficulty of the system of managed flexibility is that, unless parities are to be changed fairly frequently, it provides no variable through which international adjustment can be effected. Under the gold standard the strategic variable is the domestic cost/price structure. Under variable rates it is the rate of exchange. But with the mixed system both domestic incomes (and therefore prices and costs) and the exchange rate are to be stable so that there is no means whereby, in the short and medium term, adjustment to the foreign balance can be effected. Defenders would argue that, in the short term, there is in any case no available means of adjustment and that deficit countries must live by their reserves (or on the charity of their creditors) but that in the long period the exchange rate must be the adjuster. True, but if the adjustable peg is to have any advantage over the freely varying rate system, changes in parities must be only at long intervals — presumably of years. Continual alterations of rate would be as bad, if not worse, than a rate which moved with the market. The fact is that by attempting to reap the best of both the pure systems of adjustment, managed flexibility is not a true adjustment mechanism at all. That in itself does not condemn it: the system may with wise management prove efficient, but the case has yet to be proven.

The difficulties involved in management by national monetary authorities are three. First, there is the difficulty of deciding in given circumstances whether a change of rate should be made. Unless some clearly defined formula is adopted disputes between nations are bound to occur. Country A is certain to be as sus-

¹ That is over the 'standard period' as defined in our definition of the equilibrium exchange rate. See above, p. 51.

ing an equilibrium price level relationship.¹ And if the deficit is due to a structural shift of demand the probable effects of devaluation will depend upon a number of contingent factors — upon the size of the country concerned, on the nature of the products which it exports and upon their relative importance in its balance of payments.

Clearly the problem of defining a suitable criterion for devaluation is not an easy one. The vagueness which surrounds the IMF's criterion of the existence of a 'fundamental disequilibrium' is indicative of this difficulty and it is perhaps wise that each case should be considered exhaustively on its merits. Yet there should be a criterion, for upon the swiftness of the decision of whether a country may revalue its currency or not much may depend. This brings us to the second difficulty of management, that of timing.

Ideally an adjustment mechanism should invoke restorative forces immediately a disequilibrium begins to develop. This takes place under a gold standard where short-term capital movements serve towards correction of the deficit as soon as the central banks involved react to the gold flow by appropriate changes in interest rates. Similarly under a system of variable rates the exchange rate will depreciate immediately there is any discrepancy between the demand for and the supply of the deficit country's currency. Under the system of managed flexibility, however, correction of the deficit cannot begin until the deficit country's rate has been altered and if the alteration is itself obliged to wait upon the existence of disequilibrium being proved, then by the time remedial measures are taken the disequilibrium may be great. It is indeed hard to see how a movement of the adjustable peg can ever be anything save a crisis measure taken under the duress of a deteriorating external situation.

Defenders of the system may argue that temporary balance of payments disequilibria can be met by drawing upon national gold and currency reserves or upon an international liquidity pool. While this is true it does not meet the difficulty that the onus of correcting the disequilibrium rests upon the deficit country which must take appropriate domestic action to eliminate the deficit in its balance of payments. There is no certainty that it will do so. If the deficit is the result of its relatively high level of income it may be quite con-

¹This assumes that there has been no change in the dispersion of individual prices about the average constituted by the general price level.

tent to allow the deficit to continue as long as there are means to finance it. By so doing it will have a retarding force on its inflation provided by the deficit and, if the deficit continues for long, an argument for devaluation of its currency.

Then there is the difficulty of deciding the measure of revaluation which, in any given situation, is called for. The difficulties of actually calculating a value for the equilibrium rate have already been referred to¹ and it was seen that the alternatives were two: either to free the rate and allow it to find its own level before stabilising it, or to estimate it with the aid of the purchasing power parity formula. Since the former method is not possible under managed flexibility we are driven to the second. Apart from the difficulty of reliable estimation there exists the likelihood that a country may devalue its rate by more than is necessary. The fact that devaluations should not be made frequently may well tempt it to make a sharp once-for-all reduction which will ultimately leave the rate undervalued. Once settled the rate must be borne for a considerable period, and the country's terms of trade, export/import position and even in part its domestic stability will be thereby determined.

The fact that a country must maintain a stable exchange rate over a considerable period necessitates the holding of a large reserve of gold and/or universally convertible currencies. The longer the period during which rates are to be stabilised the greater the volume of international liquidity which the international economy requires. For that reason, if for no other, there must be supplementation of existing stocks of liquidity, either through some common international pool such as the IMF, or through a redistribution of the world stock of monetary gold.

Perhaps the greatest disadvantage which is attached to the system of managed flexibility is the role which, under that system, currency speculation assumes. Once a currency falls under suspicion of impending devaluation speculators have a strong incentive to move funds from the weak currency to one which is strong. Without fear of loss and with the growing likelihood of handsome profit the movement away from the threatened currency will continue, either until it is devalued and the currency is bought back at a profit, or until the monetary authorities in the deficit country can convince speculators that devaluation will not take place.

¹ Cf. pp. 53-6 above.

Indeed it is not difficult to imagine that, in extreme circumstances, a country might be driven to devalue its currency by pressure of speculation alone. Such speculation as this serves no useful purpose. Indeed, being a one way option, it is hardly speculation at all, but a profit made at the expense of the monetary authorities in the deficit country.¹ Because of such speculation a system of managed flexibility can be operated most successfully where there is strict control of capital movements between countries. Such control is difficult. It involves supervision of all transactions and even under the most effective exchange control systems yet evolved it has proved impossible to eliminate speculative movements.²

The disadvantages of the system of managed flexibility are, it seems, not inconsiderable. Moreover, they are disabilities which are inherent in the system as such and are not easily eradicated. Nevertheless much of the success of such a system must depend upon the institutional framework through which it functions and on the quality of the management. The fact that since 1945 such a system has in fact worked is not due to the merit of the system itself, but to the fact that it has been liberally bolstered up by direct controls over balances of payments in the major economies, and by the supply by the United States to deficit countries of its own currency. If, as the IMF Agreement required, all exchange control measures had been abandoned by 1952 we would then have witnessed the real test of managed flexibility as an international adjustment system. It seems doubtful whether, with existing institutional arrangements, the system could have worked satisfactorily.

The trouble with managed flexibility lies in confusion as to who is to manage. If it be the individual national governments how are their aims (even if similar in principle) to be co-ordinated so as to achieve the necessary parallel movements of prices and incomes; if it be an international authority how is the authority to establish power over member nations and how make it effective? Any nation which through a relative rise in its national income develops an external deficit counters the deficit not by the means which the

¹ The monetary authority in A, the deficit country, will in order to maintain the peg have to buy its own currency as long as speculators are selling it, and later, when devaluation has taken place they will have to sell it at the lower rate in order to maintain the new peg.

² A considerable measure of speculation can occur by deferment of payment for the deficit country's exports by foreign importers and by accelerated payments by domestic importers for imports — both in anticipation of a devaluation.

logic of the system demands — domestic disinflation, but by the immediate use of direct controls.

By this failure to provide for the basic price conditions which its successful operation demands, the system of managed flexibility stands condemned. That it may be preferable to freely fluctuating exchange rates as we have known them is true; that it is preferable to them as they might work under modern conditions is not at all certain.

V

It remains to consider some of the implications of those policies which seek to control directly certain items of the balance of payments. Measures of state intervention which are directed towards the balancing of the external account have become so widespread and so varied in their application, that we can no longer preserve the polite fiction that they are mere temporary aberrations thrown up by the war and its aftermath. For good or ill they have established a large foothold as means to control balances of payments, and as such we must examine their implications.

It is impossible in short compass to enumerate or to describe in detail the devices by which governments now control the international passage of goods, money payments and capital. Adequate studies have already been prepared and to these the reader must go if he wishes for detailed information.¹ Our present task is two-fold: to give a brief account of the main groups into which such controls fall, and to place the elements of the choice between the method of controls and the methods of price adjustment before the reader.²

Broadly speaking, controls fall into three main groups: financial controls which include all of the systems and devices of exchange control, of multiple currency practices, and of fiscal policies designed directly to influence specific items of the balance of payments; commercial controls which include quantitative restrictions and

¹ For a factual account on a country by country basis of existing controls see the various Reports on Exchange Restrictions published by the IMF.

² In this section we shall lump together as 'methods of price adjustment' all the preceding free systems which rely on reaction to a change in the terms of trade, either through a change in domestic price level or a change in exchange rate, to effect the necessary changes in demand.

embargoes, tariff quotas, and the buying policy of state-trading monopolies; and control of capital movements, which, although relevant to the class of financial controls, is sufficiently important to warrant separate attention.¹

Among financial controls the most elaborate is that which aims at equilibrating the balance of payments by restricting payments to other countries — in other words, exchange control. Under a system of free exchange nationals of a country may buy and sell freely currencies (or claims to currencies) of any country either for purposes of trade, travel, investment or speculation. Since the beginning of World War II restriction of this right to acquire (or to dispose of) foreign currencies has been general and almost all countries now operate systems under which foreign currencies can only be acquired by licence or allocation and can only be disposed of in ways approved by the monetary authority. There are many variants of exchange control, but one feature is basic: a monopoly of foreign exchange dealings must be conferred on the central monetary authority through whom all residents of the country must buy or sell currencies. All nationals requiring foreign currencies must purchase them from the authority (or its agents) at the official rate; all nationals who have earned foreign currencies and wish to exchange them for their own national currency can do so only by selling them to the central authority at the official rate. The central authority then fulfils the role of conserving and rationing the national stocks of foreign exchange. It can determine scales of priorities according to which currencies will or will not be supplied to importers, it can enlist the aid of customs authorities to enforce its rules, it can act as discriminating monopolist, charging low rates for exchange to be used for essential imports, high rates for that for luxury imports, and it can encourage exports to certain countries by extending advantageous rates or facilities to nationals earning specially desirable foreign currencies.

If this monopoly of exchange dealing can be established and enforced then equilibrium in the country's balance of payments can be sought by an effective rationing of the supply of foreign currencies flowing in to the authority, the demand being restricted to equate with the supply and thus maintain the chosen official rate. Although simple in principle the bureaucratic machinery which the

¹ This classification is that of Prof. Meade. Cf. *Theory of International Economic Policy*, vol. 1, pp. 263-330.

enforcement of the monopoly necessitates¹ and the variants and elaborations which have come with experience are many and formidable.

The use by the central authority of its monopoly power over foreign currency supply in order to discriminate against particular currencies or the purchase of particular products may take the form of a system of multiple exchange rates. Let us illustrate this by an example. Under the present system the British exchange control authorities work through a system of official rates of exchange purchasing and supplying all foreign currencies at those rates. Between each currency and sterling there is one official rate of exchange. Suppose, however, that exporters were required to surrender all their foreign currency earnings at a rate of $4x = \text{£}1$ and that importers of specific essential commodities were sold foreign currency at the same rate. It might well be that at such a rate not all the available foreign currency would be taken up and the monetary authority might offer the remainder to importers for the import of luxuries at whatever rate the relative supply and demand determined. This might be $3x = \text{£}1$. There would then be an official buying rate for foreign currency for the import of high priority commodities and a much higher free market rate for the import of luxuries. The effect would then be not to debar the import of luxuries but to subject them to an imposition (similar in this case to a tariff of $33\frac{1}{3}$ per cent) to the extent that the free rate was higher than the official. By the use of such a method a country may be able to dispense with the use of quantitative import controls. For this reason multiple exchange rate methods often find favour in countries which do not wish, or are not able, to maintain complex and costly direct import commodity controls.

The method of multiple exchange rates is capable of endless elaboration. By offering different rates for foreign currency according to the way in which it has been earned and charging different rates for foreign currency according to the way in which it is to be used the central authority can, in effect, impose concealed tariffs and export subsidies, encouraging the export of this or that commodity

¹ Even with elaborate machinery it is doubtful if the monopoly of the central authority can be made absolute. Two obvious leakages may occur: export and import of bank notes through the post, and export and import of notes carried by travellers. The exchange of bank notes thus illegally exported is certain to be at a depreciated rate and to the extent that the leakage occurs a black market will exist in addition to the official market.

and determining the rates of exchange according to priority in export commodities and according to its estimate of the elasticity of demand for them. Clearly such a system implies a great discriminatory power in the hands of a skilful control. Operated in such a way as to cause a decrease in the foreign currency value of imports and an increase in the foreign currency value of exports it may achieve balance of payments equilibrium for the country without the use of direct import and export controls.

Turning now to commercial controls we are in contact with some of the most familiar devices which have been used in recent years by governments to influence the balance of payments. By far the commonest of such controls is that which restricts directly the amount (either by quantity or value) of a commodity which may be imported or exported. Such a control is easily enforceable by customs authorities. It is, moreover, capable of either general or detailed application. For example it may be ruled (*a*) that no foreign cameras be imported into Britain, or (*b*) that only x foreign cameras may be imported, or (*c*) that foreign cameras, except those from Germany, may be imported, or (*d*) that a licence is required by any person wishing to import a camera. Thus it is possible to control overall quantity (or value) of a particular import and to discriminate against imports from particular countries. The main object of quantitative import control is, of course, to import only that amount of goods which can be paid for out of current export earnings. This involves a governmental decision as to the total quantity of imports. Then it will have to be decided of what the global total of imports is to be composed, what products are to be given priority and what are to be excluded. Although general principles will govern these high level decisions the application of these principles to individual cases must necessarily be left to the bureaucracy, and an elaborate system of licensing is inevitable. The most usual method is to issue licences to individuals under which they may import specific quantities (or values) of a commodity, the aggregate of individual licences being the total quantity to be allowed into the country.

The limitation of the quantity of a good imported necessarily affects the demand price on the home market, which rises as the good becomes scarce. But the supply price of the good (i.e., the price at which the foreign exporter sells) is unaffected so that a special profit accrues from the margin between the supply and

demand prices. Who is to receive this margin? Briefly it may (i) accrue to foreign exporters who raise their supply price, (ii) accrue to importers who raise their selling price, (iii) accrue to the government of the importing country who impose an import licence fee, (iv) accrue to a consumer in the importing country, who, if the price of the imported commodity is controlled, buys at the controlled price and resells at the true demand price, or (v) accrues, in part, to the officials in the importing country as a bribe for the granting of the import licence. Whether the margin accrues to the exporters or the importers (i.e., cases (i) or (ii)) is clearly important for the terms of trade. The method of import restriction should be such as to avoid the confusion of an open quota system where an unseemly rush to import before the quota is exhausted and snatch the abnormal profit is the result.¹

An elaboration of the method of quantitative restrictions is that of the 'tariff quota' whereby a specified amount of a commodity is allowed to be imported free of duty, while imports above that amount are subject to an import tariff. The scarcity of the commodity in the importing country will result in the demand price in that country being higher than the supply price at which the importer may obtain the goods. Whether import continues above the amount of the free quota will depend upon the relative size of the import tariff and the margin between the importer's supply price and the public's demand price. If there is such a margin even after the imposition of the tariff then further goods will be imported until with the decline in scarcity the demand price falls until it is equal to the supply price plus the import tariff.

Another method of quantitative import control is to prohibit all import of a given commodity by private persons and confer a monopoly of import upon a state-owned organisation. The organisation is then able to govern the amount of the commodity which is imported in accordance with national balance of payments considerations. In this case also a margin appears between the importer's supply price and the demand price of the public under conditions of scarcity, but here the margin accrues to the state organisation in the form of abnormal profit.

All commercial controls limiting the quantity of imports present the problem which is created by this margin between the supply price and the higher demand price caused by the scarcity of the

¹ For a full analysis of this problem see Prof. Meade, *op. cit.* pp. 277-87.

good. Who is to receive the margin will in the last resort be determined by the form which the import restriction takes and the way in which it is administered. In order that scarcity of the controlled commodity may not result in abnormal profits for the importer there must be either an import fee to appropriate the profit for the state, price control to prevent it arising, or direct state trading. The full analysis of this problem required to form a judgement upon the relative merits of such methods is too lengthy to undertake here. This is in fact a case where control begets a condition which demands further control — a case not uncommon once the normal working of the price system is interfered with.

We come now to the control of capital movements. Here the first problem lies in deciding what types of capital movement must be controlled; the second is how to make the control effective. With regard to the former it is evident that short-term capital movements which are unrelated to the balance of payments and which are likely to move in a contrary direction to that which stability requires should be controlled. Equalising short-term capital movements have a useful part to play in a price-adjustment system and for that reason should be permitted; but in practice it is impossible for purposes of control to distinguish between stabilising and destabilising short-term capital and the difficulty of segregation makes it inevitable that both should be controlled. Long-term capital movements are less likely to cause trouble. Control may be desirable, for a country with an unfavourable balance on current account cannot afford the luxury of investment abroad. It is in any event likely that control will be imposed for political and non-economic reasons in order to co-ordinate monetary and political policy.

The complete control of capital movements is difficult to achieve. If it is to have any chance of success it must involve a control and qualitative examination of all foreign payments. Many apparently routine transactions can conceal a capital transfer if this is not done,¹ and even with the most elaborate arrangements for exchange control it is known that evasion does take place. The speculation

¹ For example the foreign currency proceeds of an export transaction (or part of the proceeds) might be invested in foreign securities. This is prevented by exporters being liable to surrender all foreign currency to the central authority. Another method of concealed capital transfer is for exporters to understate the value of exports. For example a shipment to the United States of \$10,000 value may be invoiced at \$7,000, it being agreed with the importer that \$7,000 be paid on the invoice the other \$3,000 being paid into an account in New York for the credit of the exporter. Even under the strictest control such leakages may occur.

against sterling prior to devaluation in September 1949 is indicative of the fact that even with elaborate control a large measure of speculation against a currency may still occur. We are not here concerned with the technical problems of administering a 100 per cent 'capital tight' exchange control, but with the problem of whether such a control is desirable. That it is so seems to be indicated by the destabilising influences which theory and experience attribute to unrestricted movements of capital — particularly under the adjustable peg system.

In a country where balance of payments adjustment is sought by exchange control and quantitative import restrictions it is easy to see that control of capital movements should form an integral part of the system. Indeed such controls must remain even if direct controls over the balance of trade items have been removed, and the problem thus arises as to how control of capital movements can be reconciled with the operation of a price adjustment system.

Clearly to combine freedom in balance of payments adjustment with control of capital transfer would not be easy. A system, for example, of flexible rates would require to be accompanied by an organised market in forward exchange which in turn requires the unretarded movement of short-term speculative funds, which is just what the control of capital transfers would have to regulate. It has been suggested¹ that the two aims could be reconciled by means of a system whereby a number of licensed dealers would be allowed to hold foreign currencies and to deal in them and persons living outside the exchange control country might hold resident balances of the latter's currency. Residents would be able to obtain foreign exchange for current transactions from the authorised dealers and would have to surrender all foreign currencies to them. The dealers' balances and the balances of non-residents would then constitute a free market for speculation with spot and forward rates. Since it would, assuming the controls to be effective, only be possible to obtain currencies for current transactions the rate of exchange in the market would be that which would give balance of payments equilibrium in the absence of capital movements.

This system is very similar to that at present ruling in Britain and only slight changes in the present structure of the control would be required to achieve it. But, although it demonstrates that freedom of rate and control of capital transfer are not so irrecon-

¹ Cf. Prof. J. E. Meade, *op. cit.*, pp. 302-3.

cilable as they seem at first sight, the system would still be subject to all the difficulties of sorting out capital from current transactions, preventing evasion, and securing a searching scrutiny of all transactions.

It is difficult to adjudge the relative merits of direct controls and price adjustment systems. Clearly it must rest in part upon the relative efficiency of the various systems as adjusters of the balance of payments, and in part upon what we may call the 'welfare considerations', namely how each system influences the magnitude of world real income, and its distribution between nations. We must here confine our discussion to the first aspect — that of efficiency. This is not to say that the welfare considerations are not important — in the long-run they are vitally so — but rather that consideration of them would carry us far outside the scope of this study.

So far as efficiency in balance of payments adjustments is concerned we are face to face once more with the elasticity condition. If the elasticities of demand for imports are high then adjustment through price changes will be possible without too great a movement in the terms of trade; if the elasticities are low then resort to direct controls is inevitable if both stable domestic incomes and external balance are to be maintained. In a world which refuses to accept fluctuations of prices and of income and employment the elasticity condition becomes all important. Even if it is amply fulfilled and adjustment through changes in the terms of trade are effective it is possible to envisage circumstances in which direct controls might be the best means of short-term adjustment. The most obvious case which springs to mind is that of a country whose foreign balance is subjected to a sudden and unexpected external influence, as for example depression in one of its export markets or a sharp rise in the prices of its imports. For counteracting the effects of such shocks direct controls are effective, quick, and capable of being varied to suit the circumstances. Whatever may be their future in wider spheres, for this purpose they will find a permanent place among the economic weapons of every country.

We must not pretend that the choice between direct controls and price adjustment methods is before us, in any save the most academic sense. We now live in a world whose processes of balance adjustment are expressive of the authoritarian and neo-Mercantilist spirit of the age — economic tools in the hands of politicians used partly for economic and partly for political ends. The mere

fact that balance adjustment through direct controls carries with it the potentiality of political as well as economic motive is sure to recommend it to some as much as it makes it repugnant to others. In any event there is the plea of expediency. We have lived for more than a decade by the aid of such a system: may it not be welded to our needs? The onus of proving the case for its dismissal rests upon the advocates of the alternative systems. Of these we believe that, in a world of full employment only one is possible — a system whereby adjustment is sought by a modified system of flexible rates of exchange combined with domestic monetary and fiscal policies for internal balance.

SECTION III

'There the common sense of most shall hold
a fretful realm in awe.'

TENNYSON, *Locksley Hall*

CHAPTER 5

THE EFFORT TO BUILD AN EQUILIBRIUM SYSTEM

I

THE task of constructing an international monetary system after World War II was inextricably bound up with the broader problem of postwar reconstruction. The war had lasted for six years and the supreme effort which it demanded forced upon the co-belligerents of the United Nations a measure of functional co-operation which had no precedent and was to be of inestimable value in the joint attempt to restore ruined economies and rebuild an international economy. Moreover, the very length of the war, the fact that its end was foreseen and the worst problems of the immediate peace anticipated, enabled a greater amount of serious thinking and planning for reconstruction to be done, and planning for the peace began early. This was encouraged by the underlying belief that the imperfections and dilemmas of the 'thirties had played a great part in making the war itself and by the consciousness that the second war must not, like the first, be followed by a rush to get back to 'normal' — whatever normal might be.

Some of the tasks of reconstruction were clearly defined — as for example the supply of food and clothing to war-devastated countries — and presented no special problems other than those of immediate implementation. Others, however, meant the resumption of work upon complex and controversial issues which had defied solution in pre-war days and were now further complicated by the impact of war. Into this category fell the problems of currency stabilisation, commercial and tariff policy and employment control.

In the planning for the postwar period it was possible to distinguish three types of problems. These, although clearly they overlapped and were often interdependent, may be adopted for

purposes of classification. First, there was the immediate problem of providing relief to war-damaged countries as the tide of battle receded and as they were recovered from the enemy. This consisted in the provision of consumer goods, food and medical supplies, and of the more rudimentary types of equipment necessary to restore some measure of working capacity. Second, there was the task of reconstruction, of rebuilding shattered industries and public services, of restoring stocks of essential materials, and reorganising industry, government and finance. Third, there were the tasks of long-term planning some of which had been the subject of international discussion prior to 1939 and some of which had emerged with the stirrings of the political conscience which the war had engendered. Of these the first group claimed immediate attention¹ and after certain preliminary work in Britain and America during 1941 and 1942 the United Nations Relief and Rehabilitation Administration was set up in November 1943. In this, the first of the functional postwar international bodies, the United States was the prime mover and her participation and attitude betokened an end to isolationism and a new approach to international economic problems.

In its most general form the economic aspect of postwar planning dates from the Atlantic Charter and the Declaration of the United Nations of January 1, 1942 which expressed the wish of the Allies to 'bring about the fullest collaboration between all nations in the economic field'. This theme was touched upon only lightly by Allied statesmen during 1942 and 1943, for it was felt that, at this stage, the war position of the Allies was too unfavourable to justify the diminution of effort which postwar planning might involve. Allied leaders were intent upon securing the maximum war effort and did not wish to threaten the unity of that effort by the discussion of controversial social and economic aspects of the distant peace. In the United States the more constructive aspects of postwar planning would have been interpreted by Roosevelt's opponents as a new flowering of the spirit which had produced the New Deal; while in England the Churchillian doctrine of 'all for the war-effort' set the political tone.

Co-operation is easy among co-belligerents in war. The ends are

¹ The necessity, for political as well as humanitarian reasons, of providing food and necessities for starving European populations was realised at a very early stage of the war and the provision for relief was almost ancillary to military operations.

. clearly defined and often dictate the means. The same forces which make individual nations submit to the imposition of rigorous controls extend to the international sphere. Divergent state interests are, in the interests of common purpose, set aside and the smaller risks of advantage foregone or privilege usurped are willingly taken in the interests of survival. Then co-operation becomes predominantly functional, ends and means being considered only in relation to the immediate accomplishment of particular tasks — of munition supply, troop movement, joint productive effort and the like.

Functional co-operation between Britain and the United States began before America's entry into the war with the Lend Lease Act (March 11, 1941) which, by its virtual pooling of American supplies with those of Britain, by-passed the problems of exchange, tariffs, war loans and all that had made a continuance of the cash-and-carry formula impossible for the United Kingdom. By this act the principle was accepted that all Allied resources formed a common pool and were to be allocated according to the dictates of the overall strategic plan. As the framework of government control ramified in Britain and (to a lesser extent) in America powerful functional inter-Allied institutions were created. Between January and June, 1942, five joint boards¹ were set up to deal with problems in the fields of shipping, munitions, raw materials, food, and production and resources. With these were regional agencies responsible for the extension of these functions into key regions and theatres of war.² Most of the boards were Anglo-American; on some, other members of the British Commonwealth were represented, but many of the United Nations which were subject to the boards' authority had no representation. Nevertheless, they accepted the boards' authority willingly.

These joint boards were not established by treaty nor had they any rigidly defined constitution, powers or radius of operation. They were charged with the general task of co-ordinating and maximising productive effort and they were empowered in routine matters to deal direct with government departments in Allied countries. In this way they avoided circuitous dealings with

¹ The Combined Shipping Adjustment Board; the Combined Munitions Assignment Board; the Combined Raw Materials Board; the Combined Food Board; and the Combined Production and Resources Board.

² Chiefly the Middle East Supply Centre, the Anglo-American Caribbean Commission and the North African Economic Board.

innumerable government departments and achieved the maximum co-operation at the administrative level at which action could be quickest and most effective.

It was among civil servants and administrators that planned solutions to long-term economic problems were first sought. During 1941-42 in London and Washington groups of civil servants, reinforced by experts drawn into temporary government service by the war, were thrown into frequent contact with one another and from their interchange of ideas and sharpening of wits much was to come. Here postwar monetary co-operation began.

The initial driving-force behind the discussion of postwar economic problems between the United States and the United Kingdom was the Lend Lease (or Mutual Aid) Agreement. It had been realised at an early stage that if the postwar world were not to be burdened by a new war-debt problem it would be impracticable that Britain should repay, either in money or kind, the vast flow of Lend Lease commodities which was pouring across the Atlantic to her. The idea gained acceptance that repayment claims in respect of Lend Lease should be waived in return for a British undertaking to pursue certain policies in concert with the United States after the war. During 1941 protracted discussions took place between British and American economists, officials and politicians as to the obligations to be assumed under the famous Article VII — the earlier drafts of which had sought to impose upon the United Kingdom the acceptance of the principle of non-discrimination in her trade after the war. The main provisions were that in settlement of obligations resulting from the Lend Lease Act no conditions should be imposed which would restrict commerce, but agreement should be made on means for the reduction of trade barriers and the abolition of preferential duties. To this, British spokesmen had objected strongly and discussions took place at both administrative and Cabinet levels. Two distinct threads are traceable in these discussions both of which have relevance to subsequent discussions on international monetary issues. The first was the question of post-war trade policy, the second the problem of the British balance of payments with particular reference to the impact of fluctuations in the United States upon the employment position in Great Britain. On trade policy the American administration, under the influence of Cordell Hull, were strongly in favour of the reduction of trade barriers and of establishing the principle of non-discrimination as

an axiom to run through all postwar economic planning. The motives behind this demand were no doubt various. The belief in the necessity for freer trade among nations was strongly held by certain officials in Washington who were anxious to use this unique opportunity to further their aims. In other quarters dislike of the British system of Imperial Preference ensured support for anything that would bring about its destruction. No doubt also there was a modicum of anti-British feeling, a fear of British imperialism, and a temptation to take advantage of what was a golden opportunity to put one across on 'perfidious Albion'.

The British on their side were divided in their views. To some of the politicians the system of Imperial Preference appeared to be a symbol of commonwealth unity and it was defended on grounds of sentiment rather than economics. Among the official administrators, particularly the economists, there was little enthusiasm for Preference but there was at the same time the fear that non-discriminatory trade policies were a luxury which postwar Britain would be unable to afford. It was felt that, with the liquidation of overseas assets forced upon us during the period of cash-and-carry, the British balance of payments after the war would be in such a parlous condition that discriminatory measures would be inevitable and we could not therefore pledge ourselves to forswear them. Moreover, trade policy appeared to many to be a secondary issue — second to the major problem of providing full employment in Britain after the war and insulating her economy from deflationary influences coming from abroad.

The form in which Article VII was finally cast gave expression to both of the national aspirations. It was a compromise, Britain accepting the obligation to take part in a concerted movement towards 'the elimination of all forms of discriminatory treatment in international commerce',¹ in return for the United States' promise to participate in 'Agreed action . . . directed to the expansion, by appropriate international and domestic measures, of production, employment and the exchange and consumption of goods.'² The way was fairly opened for a co-operative attack upon postwar economic problems by the following paragraph: 'At an early convenient date, conversations shall be begun between the two Governments

¹ *Agreement between the United States and the United Kingdom, February 23, 1942*, Cmd. 6391. Article 7.

² *ibid.*

with a view to determining, in the light of governing economic conditions, the best means of attaining the above-stated objectives by their own agreed action and of seeking the agreed action of other like-minded Governments.¹ The Mutual Aid Agreement (including Article VII) was signed in February 1942.²

Article VII was intended to commit Great Britain and the United States to international economic co-operation after the war, and to embody in that co-operation two inter-related obligations, the freeing of trade and the prevention of unemployment. The fact that it was to be otherwise interpreted with the passage of time, by the Americans as the means of forcing upon Britain a policy which she was not in a position to accept and by the British as a doctrinaire dictation of terms exacted under the duress of need, was not then apparent, although by some it must surely have been foreseen. Theoretically the linking of freer trade and full employment in the plan for joint action was impeccable. Each country had bowed politely to the views of the other and while the spirit of the classical economists and of *laissez-faire* had been assuaged on the one hand, the new gods of effective demand and controlled expansion had been propitiated on the other.

Before embarking upon an account of how the two nations sought to implement the directive of Article VII it might be profitable to consider briefly the spirit and mental attitude with which each approached the task.

Certain opinions and attitudes were held in common, although in varying degree, by the American and British governments. Firstly, it was essential to avoid recurrence of the state of confusion in world currencies which had prevailed after World War I. That there should be no blind pursuit of national self-interest in economic and monetary matters was clearly recognised. Perhaps, more than anything else, both governments were determined that there should be no repetition of the monetary rivalry of the 'thirties with its competitive depreciation of currencies and widespread pursuit of beggar-my-neighbour policies. And secondly, it was felt that the principles of international co-operation and mutual support of each other's currencies which had been the basis of the Tri-

¹ *ibid.*

² For an excellent account of the events and negotiations which preceded the signing of the Mutual Aid Agreement see H. Duncan Hall, *North American Supply. History of the Second World War (Civil Series)*, London, 1955, pp. 224-328.

partite Monetary Agreement of 1936 were sound and should be the basis of any further international action.

So far as the initiative in postwar economic planning came from the United States it must be regarded as the first step away from isolationism and towards the assumption of her responsibilities as a great creditor nation. To have achieved such a political *volte face* in so short a time was in itself noteworthy. To try to classify and simplify the complex and heterogeneous mass of opinion which underlay the United States government's actions at this period is impossible, but it is possible to single out a number of threads which may be traced as running from this and through all later negotiations on monetary and general economic matters.

First, the Americans were anxious to bring to bear upon the international economy the same principles of *laissez-faire* competition as underlay their own economy. Only by the application of such principles and by the energetic extirpation of all that did not accord with them could real progress be made.

Second, the Americans had a much greater aversion to preferences in international trade than to tariffs. In this the views of Cordell Hull and the group who had worked for American acceptance of the most-favoured-nation principle in the 1920's were typical. Discrimination and preference were in the American mind linked with exchange control as engines of economic warfare symbolic of Hjalmar Schacht, Nazism and Anti-Semitism. They pressed the point of non-discrimination in international trade against the British in and out of season — in the discussions on the Atlantic Charter, in the Mutual Aid Agreement, in the Bretton Woods Agreement, in the Anglo-American Loan Agreement, in the negotiations for the establishment of an International Trade Organisation, and through their influence on the policies and views of the IMF. As with discrimination so with inconvertibility of currencies — a further manifestation of Schachtianism. With the demands for non-discrimination was coupled inevitably pressure for the early abolition of all restrictions on current payments.

Third, American officials carried into all negotiations the traditional American distrust of the banker and 'big money' interests. The same mental attitude as had forestalled the widespread adoption of branch banking in the United States and had dispersed and decentralised the Federal Reserve System played a part in determining the official American attitude towards postwar

international organisations which had to be provided with written constitutions to guard against all contingencies.¹

Fourth, the Americans, conscious of the wealth and impregnable creditor position of their country held somewhat confused views on the prospects of international monetary co-operation. In principle it appealed to them, for there was in it a tincture of idealism to catch the imagination and make its appeal to the American mind. But they were all too conscious of a growing sense of power in economic affairs and there was undoubtedly an element among them who looked upon the plans which were mooted not as schemes for international corporate action but as an American 'hand out' to the European mendicants. Maybe America would agree to the hand out, maybe not. If she did she had at least the right to call the tune.

Lastly, there was one facet of the American political scene which could never be forgotten by the British in all negotiations both before Bretton Woods and later in the talks on the Loan Agreement: the fact that the administration, with whose enlightened and able officials the British economists and civil servants had to deal, was never in a position to make commitments, but was subject continually to the revisionary or annulling power of Congress. Not only did this affect the American negotiators who were constantly aware that everything must be made to wear a good face before Congress, but it inevitably influenced British negotiators who were conscious that in making concessions they were not doing so for a *quid pro quo* 'but for promises which might, and often did evaporate in practice'.²

The British approach to postwar economic problems was very different, being the approach of a nation which had for at least a century been dependent upon overseas trade and had always been forced to orientate her economic policy around that fact. Relying on naval strength she had adopted free trade, allowed her economy to become progressively industrial, and had laid aside all thought of economic self-sufficiency. While that policy had been amply justified in war there were qualms as to its result in peace. Britain's

¹ Cf. Paul Bareau, 'Is it Goodbye to Bretton Woods?', *Three Banks Review*, March 1952.

² Cf. Minute written by Keynes on August 22, 1941, quoted in R. F. Harrod's *Life of John Maynard Keynes*, London 1951, p. 515. '... one can take nothing whatever for settled in the United States for the sufficient reason that the administration not being in control of Congress, is not in a position to enter into commitments on anything. We shall have to bear this in mind in all the negotiations for Anglo-American economic co-operation.'

adverse balance of merchandise trade during the pre-war years had only been compensated by her net income from invisible exports such as interest receipts on foreign investments and revenue from shipping and financial services. During the first years of the war she had been forced to sell much of her stock of foreign assets and who could tell what might be left when the war ended?¹ Moreover, it was clear that in the supply of shipping and financial services she would have powerful competitors after the war and income from invisibles would, at best, recover only slowly. The whole burden of the external account would then be thrown initially upon commodity exports, the expansion of which would have to wait upon the formidable task of diverting resources from war to peace production. Altogether the picture of the future British foreign balance was far from cheerful. Nor did it improve on closer analysis. It was probable that the triangular system of world trade through which Britain had found equilibrium under a system of multilateral clearing, and which had been steadily deteriorating in the decade before 1939,² would be destroyed by the war, and the prospect of a general deficit in her overall external account was only surpassed in gloom by the promise of severe sectional deficits with particular countries, especially the United States. Keynes and other British economists were well aware of what the future held in this respect and sought to bring home to the Americans the nature of the price which Britain was having to pay for her all-out war effort. On more than one occasion Keynes seems to have warned members of the American administration that Britain's postwar condition might drive her to use Schachtian methods, unless an adequate Anglo-American effort to secure international equilibrium could be made. But his warnings seem to have been politely ignored or to have invoked warnings that any experiments in discrimination would bring reprisals and that in any contest of economic strength with the United States Britain could not but fare badly.³ On the problem of the British postwar balance of payments it would certainly have been difficult for the American

¹ Actually the total sale of British foreign investments during the war amounted to £1,118 mln and the net income from overseas investments in 1945 was estimated to be less than half of that in 1938.

² In 1929 the 'transfer load' from Empire countries to Britain was £265 mln, largely met by the dollar earnings of the overseas Empire. By 1939 the transfer had shrunk to £87 mln. Moreover, the dollar-earning capacity of the Empire in the postwar period seemed likely to be smaller.

³ Cf. Harrod, *op. cit.*, pp. 512-13.

administration to make any declaration, even of general principle, and it was no doubt hoped that in the plans which would be made in obedience to Article VII some means to alleviate that problem might be found. Be that as it may no provision for Britain's special difficulties was made during the war and the problem was shelved until the sudden ending of Lend Lease in 1945 raised it in a clamant and undeniable form.

Coupled with a realisation of the foreign balance problem there was in Britain a resolve that the pre-war disease of involuntary unemployment should not be allowed to rage unchecked. Keynesian economic teaching reached its floodtide of popularity in Britain during the later years of the war and with the desire to prevent unemployment went the belief that we were now in possession of the means to prevent it. Although unemployment in the 'thirties had not reached such a high average level in Britain as in the States, it had persisted throughout the interwar period. Since the postwar boom ended in 1920 until the outbreak of war in 1939 the number of unemployed had never fallen below a million. Between 1925 and 1929 when the other great powers had enjoyed moderate prosperity the over-valuation of the pound had induced surplus capacity in British export industries, and the fact of unemployment in such industries ensured the continuous existence of heavy unemployment in the areas where they were located. This regional unemployment was far greater than the national average, was hard to counteract, and caused acute social distress. Coupled with the recollection of this economic malaise there was, after 1940, a growing sense in Britain of the need for active policies and a change from the spiritless fatalism of pre-war governments. The demands for postwar reconstruction of the domestic economy were clamant and sustained and the same economists and civil servants who were concerned in the international planning of 1941-44 were also busy in Britain with the preparation of the plans for full employment which found expression in the White Paper on Employment Policy in 1944. In the minds of British negotiators the necessity to provide for a high and stable level of employment after the war was second to none.

The desire to avoid unemployment in the postwar period was largely responsible for Britain's aversion to the idea of any return to the gold standard. Rightly or wrongly the return to gold in 1925 and the over-valuation of sterling during the period which followed

was regarded as a mistake. This view was reinforced by the swift recovery of British exports after the depreciation of the pound in 1931. It was generally felt in Britain that, as a system of international adjustment, the gold standard had outlived its usefulness and new arrangements must be sought. Any suggestion that the gold standard should be restored in Britain after the war would certainly have been coldly received in 1941 and even when the Keynes and White Plans appeared in 1943 criticism was directed at the role which gold was to play under the Plans.

Finally, the British attitude towards postwar monetary planning was conditioned by the usual British distaste for elaborate *a priori* planning and dislike of rigid systematic arrangements. The British preference was for a framework around which later arrangements might fructify; the American desire was for elaborate planning and written constitutions for bodies which once they were brought into being could be relied upon to operate along set lines.¹

In implementing the directive of Article VII means had to be found of synthesising all these national hopes, aversions and fears. The latent and youthful-seeming idealism of the United States had to be married with the cautious and empirical approach of the British. In such an admixture of thought and opinion as resulted, it is not surprising that the lead should have been taken by personalities, and that the process should have been one where group discussions worked upon the plans put forward by the leaders. In all that was to follow in monetary planning in the three years after the signing of Article VII two figures dominate: Harry Dexter White, a Harvard economist who had become director of monetary research in the United States Treasury in 1940, and Keynes, then at the height of his power and influence, who had, since 1940 been attached to the British Treasury. Although surrounded by many

¹ English comments upon the final draft of the Joint Statement (April 1944) were predominantly favourable because of the greater flexibility of the revised scheme as compared with the earlier plans (cf. *The Economist*, April 29, 1944; *The Times*, April 22, 1944; the *Manchester Guardian*, April 24, 1944). The American view was that the scheme had become so elastic as to be in danger of being meaningless (cf. *New York Times*, May 24, 1944). Harrod contrasts the Keynes view of the Bretton Woods institutions with that of Vinson (U.S. Secretary of the Treasury from 1945 in succession to Morgenthau). Vinson took the view that these institutions, once set up might be relied upon to operate in a businesslike way according to the principles which had been agreed upon. Keynes's view was different. The formal agreements were only a beginning. It was in operating and developing the institutions that danger lay. Only after a period of development with growing confidence, power and prestige would the institutions be safely launched. Cf. Harrod, *op. cit.*, p. 626.

economists and civil servants of ability and experience who made great contributions to the final outcome, it was around the plans drawn up by these two that discussion centred.

The signature of Article VII invoked activity in Whitehall. The first task was to draft an outline of the international economic measures which would be required to implement the obligations of Article VII and an informal discussion between a British economist and an American diplomat produced a preliminary arrangement that postwar economic plans should include the following:¹

1. An international organisation for the maintenance of exchange stability and to deal with balance of payments problems in member countries;

2. An international organisation to deal with long-term international investment;

3. An international agreement on primary commodity price-control;

4. International measures for the reduction of trade barriers;

5. The international organisation of relief and reconstruction; and

6. Measures to maintain full employment.

The idea was firmly grasped from the outset that international economic planning must be thought of as a concerted whole and not as a series of fragmented measures. On each aspect long and elaborate work would have to be done before detailed blue-prints could be drawn up. We are here concerned with points 1, 2 and 6. Points 3 and 4 will reappear from time to time for the whole scheme was inter-related, but they are not within the scope of this book.

Washington was slow to respond to the stimulus of Article VII. No meeting of American and British officials took place during 1941. In the autumn of that year Keynes was already working on the first draft of his 'Proposals for an International Clearing Union'. This was subjected to exhaustive criticism and redrafting in Whitehall and was ultimately handed to the Americans (August 1942) as a means of showing the way in which the British were approaching the problem.² Almost simultaneously an American plan for a

¹ Cf. E. F. Penrose, *Economic Planning for the Peace*, Princeton 1953, pp. 39-40.

² Mr. Penrose tells us that the delay on the part of Washington in arranging an informal meeting of experts began to cause fear that ideas in London and Washington would 'harden' too much before discussion could take place. It was suggested that to prevent this there should be an exchange of papers between the two sides. Of this the Keynes Plan was the British contribution. Cf. Penrose, *op. cit.*, pp. 39-41.

stabilisation fund prepared by Dr. Harry White was forwarded to London. These two plans, known respectively as the Keynes and White Plans were to form the basis of the negotiations which occupied the next two years. It is therefore necessary to scrutinise them fairly closely.

II

It is perhaps best to recognise at the outset the objectives which the Keynes and White Plans had in common. Both provided for control by an international agency over exchange rates; both provided for supplementation of national stocks of international liquidity; both placed supervisory powers in the hands of the agency with regard to such actions by particular countries as might threaten international equilibrium; and both provided for the machinery of multilateral clearing. Both resumed the work of international monetary co-operation from the point where it had been interrupted by the war, moving forward from co-operation by treaty to co-operation through an international agency.

The Keynes Plan was the grander and more daring in conception of the two plans. In preparing it Keynes brought to fulfilment ideas on the problem of international co-operation which may be traced back through all his economic writings since 1918¹ and he sought now to apply to the world economy the ideas which had been hitherto applied on a national scale only. The proposal (although it must have been revised many times) still bears the stamp of Keynes's personal genius. It is clearly written in a style free from the jargon common in official papers and the grandeur of its conception is apparent from the first page. Perhaps in making his proposal on such a scale Keynes sought to appeal to the latent idealism of the American mind.

Although the objectives of the Plan were comprehensive its underlying pattern was simple. An International Clearing Union was to be set up whose task it would be to administer a 'quantum of international currency'² suited in amount to the needs of world trade and capable of deliberate expansion and contraction in order to preserve an appropriate level of world effective demand. This

¹ There is some similarity between the Clearing Union Proposal and a scheme for an international gold note issue put forward in his *Means to Prosperity* in 1933.

² *Proposal for an International Clearing Union*, Cmd. 6437 of 1943, p. 5.

quantum of world currency was to be the aggregate of a series of overdrafts in favour of the member countries, each country's maximum overdraft (or quota) being determined according to a stipulated formula.¹ The quantum was to be expressed in units of an international currency known as 'Bancor' whose value in terms of gold would be defined and which would be accepted by members as the equivalent of gold for the purpose of settling international balances. Each member state would agree to accept payments from other members by a transfer of Bancor to their credit in the books of the Union. The central banks of member states would maintain accounts with the Union through which exchange balances between them might be periodically cleared. Countries whose balances of payments with the rest of the world were in surplus would thus have a credit in their accounts with the Clearing Union; countries whose balances were in deficit would have debits. A member's quota with the Union would thus serve to supplement its own gold and currency reserves as a means of meeting deficits in its balance of payments and avoiding disequilibrium either in the world economy or in its own domestic economy.

The principle of the Clearing Union was simply the principle which underlies a closed banking system — the necessary equality of debits and credits. So long as credits could not be removed from the system, but only transferred within it, there could be no danger of insolvency. The Union could make overdraft facilities available to its members (as a bank creates deposits by making an advance) knowing that the proceeds could only be transferred to the credit of another member. Moreover, the Clearing Union required no initial deposit of gold or currencies from its members. Its assets were book figures only and the Union was responsible for the accounting. This had the advantage of making the quotas of members (and of course the aggregate resources of the Union) flexible, capable of being increased by agreement if the general level of prices were to rise or the volume of international trade to increase with the passage of time.

The Clearing Union was designed also to fulfil the rôle of an international stabilising mechanism. A deficit country was to be

¹ The initial quotas were to 'be fixed by reference to the sum of each country's exports and imports on the average of (say) the three pre-war years, and might be (say) 75 per cent of this amount, a special assessment being substituted in cases (of which there might be several) where this formula would be, for any reason, inappropriate.' Cf. *ibid.*, p. 7, para. 6 (5).

allowed to draw upon one quarter of its quota within a year unconditionally if it so wished. If its debit balance exceeded a quarter of its quota on the average of two years the approval of the governing body had to be given before further drawings could take place, and if the deficit country wished to increase its debit balance to more than half its quota the governing body had the power to require the country (*a*) to devalue its currency, or (*b*) institute control of outward capital transactions, or (*c*) surrender a part of its national reserves of gold and currencies in liquidation of its debit balance with the Union. If a member's debit balance exceeded three quarters of its quota the authority had the power to demand prescribed action to alleviate its deficit on pain of being denied further access to the resources of the Union. On no account was the debit balance of a country to exceed its quota. In the case of a member country which, through a persistently favourable balance of payments, acquired a credit balance with the Union greater in amount than half of its quota, it should (while retaining the ultimate decision in its own hands) consult with the governing body as to 'what measures would be appropriate to restore the equilibrium of its international balances'. Suitable measures are suggested — domestic credit and demand expansion, an upward revaluation of the currency unit, the removal of any discouragement (such as tariffs) to imports, and expanded overseas investment. As a tentative suggestion the Keynes Plan also suggested that a credit balance which remained unused for a certain period of time should be automatically cancelled. Thus if a country continued on total current account to export more heavily than she imported, she would accumulate credits which she would lose unless she were to spend them prior to a given date. This placed a certain penalty upon chronic creditor countries and gave an inducement for them to adjust their external balances. At the same time it might well be that a debtor country (or countries) would continue to import long after their external accounts were in deficit knowing that with time their liability would be liquidated. Perhaps this sanction was too drastic. To the American mind it certainly seemed so.

On the subject of exchange rates the Keynes Plan was not explicit. Clearly it envisaged a system of stable rates variable according to need. For example in the case of a deficit country whose debit balance exceeded half of its quota, the governing body

of the Union might require a stated reduction in the value of the member's currency, provided that was deemed to be a suitable remedy. Again a deficit country whose debit exceeded a quarter of its quota was permitted a 'once-for-all' reduction of 5 per cent in the value of its currency without obtaining the authority of the Union. Thus the Plan meant a virtual surrender by deficit nations of control over their own exchange rates, for a deficit country could only change its rate (apart from the once-for-all 5 per cent) on the authority of the Union, and if the deficit continued and the debit grew to half its quota, it could be forced by the Union to submit to revaluation if that were deemed by the Union to be the appropriate means of meeting the deficit. True, creditor countries were under no direct compulsion to revalue their currency but it might have been hard in practice for them to resist the will of the Union.

The Keynes Plan was not only a long-term plan for dealing with balance of payments disequilibria, but was also designed to provide relief (over and above what might be made available through other measures) during the immediate postwar period. Keynes hoped that it would be brought into operation 'at an early date after the termination of hostilities'. Clearly he was aware of the danger that the operation of the scheme under highly abnormal conditions might entail, but this seems to have been outweighed by fear that if the world waited too long and the enthusiasm for co-operation waned the chance might be lost for ever. 'We must not allow excessive caution to condemn us to perdition.'

Finally, one or two of the administrative aspects of the Plan are worth noting. Firstly, the Union was to be 'of a purely technical and non-political character'. Keynes saw it as a *venue* where central bankers might meet and, in secret, exchange advice and ideas. It would be operated by international civil servants. Secondly, it was to have executive offices in London and New York and the governing body was to meet alternately in London and Washington. Here again Keynes wished to minimise political interference. No doubt he had in mind the unseemly wrangle which had taken place twelve years before as to the location of the BIS when the leading governments had vied with one another to have the pie near to hand so that fingers could be inserted from time to time. This provision in the Clearing Union Proposal foreshadowed Keynes's chagrin when at the first meeting of the IMF at

Savannah it was decided that the Fund should have its offices in 'the nationalistic whispering gallery of the Embassies and Legations of Washington'.¹

The importance of the role in which Keynes hoped the Clearing Union would be cast can be appreciated by a reading of the seven objects set forth for the Plan² and of Section IX in which additional international uses for the Union are discussed. Keynes hoped the Union would be a world-accepted institution which would grow in prestige and power with the years, acquire new functions and 'might become the pivot of the future economic government of the world'.³

By comparison with the Clearing Union Proposal the White Plan⁴ was a sober and prosaic document.⁵ Couched in terse and unimaginative language it presented its material in a form which was businesslike and direct. In certain of its aims it resembled the Keynes Plan, but as a document it showed a shrewder political sense than its fellow for it was cast in a form and contained proposals less likely to inspire alarm and obstruction in the more reactionary groups in Congress and the United States.

The White Plan provided for the establishment of an 'international stabilisation fund with resources and powers adequate to the task of helping to achieve monetary stability and to facilitate the restoration and balanced growth of international trade'. To this fund member nations would each contribute a specified

¹ Memorandum by Lord Keynes on Savannah, March 27, 1946. Quoted in Harrod, *op. cit.*, p. 630.

² Cf. Cmd. 6437, p. 5.

³ *ibid.*, p. 18.

⁴ The full title of the White Plan was 'A United States Proposal for a United and Associated Nations Stabilisation Fund'. Page references are to the HMSO reprint version published in April 1943.

⁵ This description applies only to the final version published in April 1943. It seems that in its earlier drafts the Plan was much more ambitious. It had contained proposals for an international bank and a stabilisation fund. The fund was to be an internationally administered body dealing exclusively with balance of payments adjustment and was to be designed on the lines of the British and American stabilisation funds of pre-war days. But the bank was to be a grandiose international central bank with the right of note issue and holding the deposits of national central banks. It was to be concerned with international anti-cyclical policy and primary commodity stabilisation schemes and to have many important functions. White first produced this scheme in January 1942, at the third Pan-American Meeting of Secretaries for Foreign Affairs in Rio de Janeiro. In the various drafts which were produced before the scheme was made available to the public there must have been some drastic whittling down. Cf. J. P. Young, 'Developing Plans for an International Monetary Fund and a World Bank', *Dept. of State Bulletin*, vol. XXIII, no. 593.

amount¹ (quota), the aggregate of the quotas being at least \$5 bln. The quota was to be paid partly in gold, partly in the national currency, and partly in government securities of the country concerned. Only 50 per cent was to be paid initially and the balance could be called up as required by the Board of Directors of the fund. From this fund a member nation whose balance of payments was in deficit might purchase the currency or currencies which were for the moment scarce to it in exchange for its own. This it might do only up to the point where the fund's holdings of its currency equalled 200 per cent of its quota. Before that time was reached the member nation would be obliged to 'carry out measures recommended by the fund designed to correct the disequilibrium in the country's balance of payments'. In no sense was access to the fund's resources to be automatic but in all cases the fund was to have the right to place conditions upon the supply of currencies to deficit countries and requests for accommodation were to be subject to close scrutiny. Former deficit countries were to be allowed to buy back, for gold or approved currencies, the fund's surplus holdings of their currency. Thus the fund was to provide a pool of gold and currencies which was to augment the national gold and currency reserves of member nations and provide a greater total stock of international liquidity.

The White Plan, too, had its international unit of account, the Unitas. This, however, had little significance, the Unitas being in effect only a unit (equal to \$10) in terms of which gold deposits of member countries with the fund should be expressed. Thus while Bancor was a true international currency transferable within the Clearing Union in settlement of international debt, Unitas was merely a name for gold to the value of \$10. It seems probable that at some early stage of the development of the White Plan Unitas had been cast for a more prominent role but in the version which was ultimately presented to the British it was, as Keynes said, a mere 'vestigial survival'.

¹ The amount of the quota would be determined according to an agreed formula, which would give weight to such factors as the country's holdings of gold and foreign exchange, the fluctuations to which its balance of payments was liable and its national income. Since voting power in the management of the fund was to be *pro rata* with the size of the quota the scales were heavily weighted on the side of the United States. This linking of political supremacy in the Fund with size of contribution was yet another manifestation of the American view of postwar planning as being linked with dollar charity. The linkage was so apparent that it is probable that the sweeping power which White claimed for the United States in the early drafts of his plan were put in by him as a bargaining counter.

The fund was also intended to act as an adjustment mechanism. Deficit countries were at an early stage required to adopt the fund's recommended policies for adjusting their balances of payments and the fund could impose conditions upon the supply of further foreign currency. Once its quota was exhausted no more foreign currencies were to be supplied to the deficit country. If, at the other extreme, the fund found that its holdings of a currency were in danger of becoming depleted (because of the persistently favourable balance of payments of the country concerned) it would first advise the surplus country as to measures which would serve to alleviate the shortage of its currency and, if the shortage persisted, then 'inform the member countries of the probable supply of this currency and of a proposed method for its equitable distribution, together with suggestions for helping to equate the anticipated demand and supply for the currency'.¹ It will be noted that the provisions under the White Plan for adjusting a disequilibrium in a national balance of payments resembled those under the Keynes Plan although the latter was sterner in forcing remedial measures upon deficit countries. Neither plan applied any effective sanction against surplus countries² but the White Plan, because it worked on the deposit rather than the overdraft principle, was forced to resort to the rationing of the currency of a surplus country. The British were anxious that it should be accepted as a point of principle that a part of the burden of adjustment should be shared by the surplus country, and that some form of sanction should be applied against such a country to force it to take corrective action. This was one of the main points at issue between the British and Americans during the preliminary negotiations.

The White Plan was more militant than its British counterpart on the subject of exchange rates. These were to be fixed by the fund in its own currency dealings and were to be changed 'only when essential to a correction of a fundamental disequilibrium and be permitted only with the approval of four-fifths of member votes'.³ This difference in the plans reflected a difference of national attitudes on exchange rate management. Throughout the 1943-44 negotiations Washington pressed for a rigid international manage-

¹ Cf. 'United States Proposal,' p. 7, sec. 7.

² The Keynes Plan did provide for the levying of interest upon credit balances rising above a certain level. It is doubtful if this would in practice have proved an effective sanction.

³ *ibid.*, p. 6, sec. 2.

ment of exchange rates, denying in particular the right of any country to change its exchange rate unilaterally. London, thinking no doubt of the rôle of sterling as an international currency, was loath to surrender the national right to fix the currency's value and pressed for greater flexibility than the arrangements which the White Plan provided.

Perhaps the most interesting feature of the White Plan was the section¹ which proposed a means of liquidating the blocked sterling balances which had accumulated during the war as a result of Britain's necessity to obtain primary commodities, equipment and services from certain countries for the war effort. In attempting at such an early stage to devise means of dealing with this problem² White showed great shrewdness and rare appreciation of the sort of currency problems which would have to be met when the war ended. Had such a proposal been acted upon and applied to the IMF it would have brought the Fund into the centre of postwar currency discussion, instead of its being relegated to the holding of a watching brief to which there seems to be no end yet in sight.

Last but not least, in its proposals for the management of the fund the White Plan was symptomatic of the approach of the Americans to all postwar monetary problems. It was not to be managed and directed by an international economic intelligentsia but by a Board of Directors each of whom was to be appointed by a member government. In the taking of major decisions the voting power of the directors was to be proportional to the size of their country's quota, and, under the formula suggested, the power of the United States would be preponderant. It required little foresight to see that if the fund were located in the United States the American directors, conscious always of their government's watchful eye, would discharge their duties with vigilance and use their large block vote to good (American) purpose. Couple this with the close scrutiny to which members' demands for accommodation were to be subjected and it will be clear that from the outset the international character of the fund was in jeopardy.

A great deal has been made by some writers of the similarity of

¹ *ibid.*, p. 7, sec. 9.

² Briefly the Plan proposed that the fund should purchase the blocked balances from the holders on condition that after three years had elapsed both the debtor country and the former creditor should each begin to repurchase 40 per cent of the total at the rate of 2 per cent per annum — there being no restriction on the convertibility of the amount so repurchased by the creditor.

the Keynes and White Plans — so much so that it has often appeared that the choice was, in the last resort, merely a matter of personal prestige and pride of authorship. This is not so. The Plans resembled each other in aim and purpose and administratively in superficial and minor respects,¹ but on the vital issues — the size of the pool of international liquidity, the automaticity of access to it, the banking, deposit-creating and clearing character of one, the subscribed capital and loan-making functions of the other, the conception in the mind of each man of what his agency would in fact become — on all these they differed and the differences were fundamental. The choice of one plan or the other was a vital one which would go far to settle the fate of the whole postwar experiment upon which the planners had embarked. The differences of method and scope of the two plans were such as permitted of no compromise. Before a further step forward could be taken a choice as to which plan was to be the basis of further negotiation had to be made. Into this choice elements other than the economic were sure to enter. The British had nothing to lose by pushing a plan as grandiose as that for the Clearing Union; the Americans, being human, were sure to prefer their own plan, if only because it was their own. But predominantly to the American negotiators the problem resolved itself into how they could overcome the retarding, revising and even nullifying power of a constitution admirably suited to block

¹ Nothing has been said above of the use of gold in the two schemes. In the Clearing Union gold was to play a twofold function: as a unit of account by reference to which the price of Bancor and the value of all member currency units were to be defined; and as a form of international liquidity for such countries as possessed it and wished to use it as such. Bancor balances were to be obtainable at the Union for gold while central banks were to be allowed to retain separate gold reserves and ship gold to one another provided they used it for settlements at the official parity. This arrangement meant that the interests of the gold producers (and of the gold hoarders) would be served, while allowing for a progressive demonetising of gold in the future if that seemed desirable. Under the White Plan gold was to have three functions. First, it was to form part of the quota deposit to be made by member countries. Second, the fund was empowered to accept deposits in gold from member countries. A 100 per cent reserve in gold was to be held against all such deposits which were to be redeemable in gold or in any member currency. This would enable a gold-holding member to acquire a currency through the fund, but this advantage was more apparent than real, for clearly only the currencies of deficit countries would be available. And thirdly, the fund might buy scarce currencies for gold but only with the gold quota deposit of the country whose currency was scarce. Thus it will be seen that while both Keynes and White Plans retained gold as a monetary medium its uses were restricted. Both plans steered a middle course between the gold standard, which would have been unacceptable to several of the leading countries and the demonetising of gold which would have been opposed by the gold producers and by the United States.

plans which were even mildly progressive. Whatever the economic merits of a plan it had to be such as Congress would accept, else it would be doomed to rejection.

The Clearing Union Proposal was dropped at a comparatively early stage of the negotiations in favour of the White Stabilisation Fund. The main reason for this was the great size under the Union of the proposed aggregate of quotas, which amounted to some \$30 to \$35 bln. The situation which would be faced in the immediate postwar period would be one in which there was one dominant creditor (the United States) faced with many impecunious debtors unable for some years to earn their keep or even to shift for themselves. Initially it would be inevitable that a great part of the quotas of these debtors would be used to demand imports from the United States. Such pressure of foreign demand, coupled with high domestic demand pent-up during the war years, and the clamant needs of postwar reconstruction would, it was argued, cause serious inflation in the United States.¹ To this well founded fear was added (after the publication of the Plans in April 1943) much loose and irresponsible talk of the predilection which Keynes was supposed to have for inflation and the way in which the burden of postwar inflation was now to be passed to the United States. In fact Keynes was well aware of the danger of postwar inflation and of the aggravation of the inflationary tendency which the expansionist nature of the plan might create.² But in his view that was a risk worth taking in the interests of the long-term advantages which might be reaped from the plan. Clearly it was impossible to produce a plan which was without some contingent risks and, if such there must be, better the risk of inflation than the risk of unemployment and all that a recurrence of that evil might involve socially and politically. The argument that the Keynes Plan might have had an inflationary effect upon the United States economy was an impor-

¹ Making the extreme assumption of one creditor country among all the states of the Clearing Union and that all the deficit countries exercised their drawing rights, the credit balance of the surplus country might amount to 75 per cent of the sum of all the quotas except its own. Applying this argument, if all the world were to join the Clearing Union the sum of the quotas (based on Keynes's formula) would have been \$36 bln. The United States' quota would be \$3 bln. Thus the pressure on the United States would be measured by 75 per cent of \$33 bln, i.e., about \$24 bln. Under the IMF the United States' quota of subscribed currency is \$2.75 bln and this would be the limit of abnormal demand. The above estimates are those of G. N. Halm in his *International Monetary Co-operation*, p. 85.

² Cf. *Proposals for an International Clearing Union*, Cmd. 6437, p. 19, para. 41.

tant one,¹ and was in the event fatal to the acceptance of the plan, but the difficulty could have been met without rejecting the plan as a whole. A Clearing Union of more moderate size might still have been a better solution than a stabilisation fund based upon the deposit principle. Certainly an adoption of the overdraft principle would have allowed greater flexibility in adjusting the size of the Union. It is easier to revise book-figures and raise the ceilings of overdraft facilities than it is to extract hard cash from member nations. That a revision of quotas would be necessary was a factor which surely was foreseen.² It could hardly have been expected that the world price-level and the volume of international trade would remain frozen at the 1944 level.

It is tempting to reassess the alternative plans in the light of subsequent events, but that would do less than justice to them and would serve no purpose. It is easy to be wise after the event. There was at the time much to be said in favour of both plans and it must be remembered that both were prepared as preliminary drafts upon which extended negotiations and ultimately an international conference were to be based. As blue-prints both were of a high order of competence.

III

During the autumn of 1942 and the early part of 1943 the two plans were closely studied in London and Washington. There is every indication that neither side liked the other's plan, and views and ideas were clearly being adjusted before continuing the negotiations.

The most important adjustment which was made during this period was the writing into the American Plan of the famous 'scarce currency' clause, which appeared in the draft of December 16. This was an important American concession to the British wish for a sanction against creditor countries. In so far as the Keynes Plan had provided for the piling up of large credit balances to a surplus country, in so far as these might be regarded

¹ For a statement of the argument see: J. H. Williams, *Postwar Monetary Plans*, (Third Edition) New York 1947, p. lxviii; G. N. Halm, *op. cit.*, p. 85, Imre de Vegh 'The International Clearing Union', *Amer. Econ. Review*, September 1943, vol. 33, no. 3.

² It was certainly foreseen by Keynes. Penrose tells us that at the first meeting between Keynes and White in the summer of 1942 Keynes argued that the Fund proposed by White would not be large enough. White retaliated by saying that it was the most Congress would stand for. Cf. Penrose, *op. cit.*, pp. 47-9.

- (b) the fund must be based upon the contributory rather than the overdraft principle;
- (c) the financial commitment of the United States must be limited, and not exceed two or three billion dollars; and
- (d) the United States must have a veto over any change in the gold value of the dollar and over any change in the gold value of the proposed new currency unit.

These minimum conditions were laid down in a letter of July 24, 1943, sent by White to Keynes. On August 10, Keynes replied, accepting the conditions in substance, but stating that if Britain were to accept the fund proposal there must be greater flexibility in exchange rates and the proposed gold subscription must be reduced.¹

As soon as the fact that the Americans would not accept the Clearing Union Proposals became apparent in London attention swung to the White Plan, its deficiencies, and how they might be met or removed. Briefly, the British objections to the plan were four in number. Firstly, it was drawn on too small a scale. The \$5 bln, proposed for the stabilisation fund, was inadequate considering that it was a once-for-all contribution and considering the sharp rise in prices which might be anticipated after the war. Aggregate quotas should be 10 to 12 billion dollars. Such a small addition to the stock of international liquidity could scarcely inspire confidence in hard-pressed debtor countries or turn their thoughts to the dismantling of protective controls. Secondly, the quota subscription under the White Plan, being based partly upon foreign trade and partly upon gold holdings and national income, would, with the provision for four-fifths majorities, ensure a key position in the fund for the United States. Thirdly, there should be greater flexibility of exchange rates. It was hard to accept the requirement of approval by a four-fifths majority vote for a change in parity. And fourthly, the White Plan, because of its predominantly functional character of a fund wedded to foreign balance adjustment was less fitted than the Clearing Union to fit into the broader and more ambitious structure of postwar economic planning for which Keynes and many of the British had hoped.

In April 1943 it was decided to publish both of the plans and they appeared simultaneously in Britain and America.² Not long

¹ Cf. J. P. Young, *op. cit.*

² Penrose alleges that they were published because of leakages of information which had occurred both in London and Washington.

afterwards (in June 1943) when a series of talks on postwar monetary problems were held in Washington between representatives of 19 nations¹ the Canadians added a third proposal — a compromise between the Keynes and White Plans — which was closely discussed. It could scarcely be said that the planners lacked material to work on.²

By the time the British and American negotiators met in September 1943 the British had yielded to the necessity of limiting the liability of creditors. This could still have been achieved by modifying the Clearing Union Proposal, but the Americans with their foot firmly in the door, threw all their weight against it. Congress would never accept the Keynes Plan. If the White Plan could do all that a modified Clearing Union could do why not the one which Congress would accept? Better the White Plan than no plan at all. It was finally decided that the Stabilisation Fund proposal should serve as a basis and that Keynes should erase from it all that he objected to and make any additions he wished.³ The resulting document should then be exhaustively discussed section by section. After running the gauntlet of discussion and modification by both sides during the winter of 1943–44 the revised plan was published in April 1944 as the *Joint Statement by Experts on the Establishment of an International Monetary Fund*.⁴

Three other matters which were discussed at the September meeting deserve notice. The first was that of exchange rates. Both Keynes and White agreed that a rate, stable in the short run but variable in case of need was desirable. On the principle of managed flexibility there was no difference of opinion. Disagreement was centred upon the question of who was to manage and what were to be the criteria applied in the alteration of an exchange rate. The White Plan demanded that a change of exchange rate could only be made with the consent of the fund with the approval of four-fifths of member votes; the Keynes Plan demanded consent for a change of more than 5 per cent from the original parity. At first sight this seemed of little use for such a small once-for-all change would scarcely have been worth making. But Harrod tells us⁵ that

¹ These were not the talks referred to on p. 134 but were held a few days before the discussions with the British.

² *Tentative Draft Proposals of Canadian Experts for an International Exchange Union*, Ottawa, June 9, 1943.

³ Cf. Harrod, *op. cit.*, p. 565.

⁴ Cmd. 6519 of 1944.

⁵ Cf. Harrod, *op. cit.*, pp. 563–4.

in the earlier drafts of the Clearing Union Proposal this clause had read '5 per cent in a single year' which was, of course, a very different matter. Such a provision would have permitted the gradual checking of a disequilibrium as it arose rather than the long-run major change of rate which its elimination made necessary. Moreover, the logic of the system of long-run changes demanded a large cushion of liquidity to support the rate during the period of disequilibrium. The reduction in the size of the cushion which the substitution of the fund for the Clearing Union represented was an excellent argument for such a system of rate adjustment as Keynes had originally envisaged. The White Plan seemed to neglect the fact that the frequency of exchange rate changes and the size of the fund were closely linked to one another. In the final event a compromise arrangement allowing a once-for-all revision of parity of 10 per cent was agreed to.¹ The question of exchange rate adjustment does not seem to have bulked so large in discussion as one might have expected, considering the controversies on this subject which raged during the 'twenties and 'thirties and the rather rigid views which the IMF has held since 1947.

The second difficulty was the fundamentally different conceptions which the British and Americans had of the fund. To the former, particularly to Keynes, the fund was to be an automatic institution operating with a minimum of discretion on the part of its management, allowing automatic access to its resources up to the limits of members' quotas and having no direct influence or control over the national policies of members. It would be small, in management and staff, and to preserve its international character it would meet alternately in the largest member countries. The American view was somewhat different. They envisaged a large and well-staffed bureaucracy presided over by politically appointed directors, exercising control and scrutiny over all drawings from the fund, and with discretion to promote what it considered to be appropriate domestic policies among its members. This difference of view was glossed over in discussion. The British misgivings were soothed, but time and again in the negotiations which were to follow and at Bretton Woods and Savannah this cleavage reappeared.

¹ The British views on the exchange rate problem were put to the meeting in a memorandum by Keynes entitled 'Exchange Rates'. In this it was suggested that the fund should not withhold its approval of a proposed change if the change, inclusive of previous changes, did not exceed 10 per cent within any ten year period. Presumably the ten year condition was dropped at a later stage.

Ultimately it was the American conception which prevailed, with effects which shall be apparent when we come to consider the record of the IMF.

And lastly, there was the question of the fund's possible interference with matters hitherto considered as the prerogative of national monetary institutions. Here the British were particularly uneasy. What would be the attitude of the fund to national policies and to the organisations which implemented policies? The Bank of England was alarmed by the prospect of a fund which would hold deposits with it in the use of which the fund would be the sole arbiter. Moreover, if the fund were to operate on national money or stock markets, might its operations not be inimical to the interests of domestic institutions operating in these markets? Under the Clearing Union each country was to have Bancor deposits with the Union and this problem would not arise. An attempt was made to alleviate these fears by invoking an unimportant aspect of the White Plan. Under the original draft of this plan a new international unit of account, known as *Unitas*, had been called into being. The accounts of the fund were to be kept and furnished in terms of *Unitas*, but the unit had no real importance and could have been dispensed with without altering the plan. The British now proposed that the fund should be given a 'neutral' character by avoiding the system under which the fund's resources would be held as deposits with member central banks and should substitute member deposits with the fund measured in terms of *Unitas*. This suggestion became known as the plan to monetise *Unitas* and was embodied in a memorandum by Keynes entitled 'Suggestions for the Monetisation of *Unitas*' and dated September 21, 1943. It was discussed throughout the various drafts which followed but American resistance to the 'banking principle' being embodied in the fund was strong and it was eventually dropped.

The position then following the Washington meeting of September 1943, was that Britain and America were committed to a joint effort in international monetary co-operation; that the stabilisation fund of the White Plan was to be the basis of this effort, but that it should be modified to accord with the British view. The amount of capital subscribed had been increased from \$5,000 mln to \$8,000 mln. The arrangement for exchange rate adjustments had been made more flexible, gold subscriptions to the fund had been sharply reduced, the right of a member nation to withdraw from

the fund had been conceded, and the scope and authority of the fund had been defined.¹ The scarce currency provision remained and had been reaffirmed. Perhaps most important of all, the White Plan measures for dealing with postwar indebtedness had been abandoned and it was made clear that the fund should 'not become operative until it is satisfied as to the arrangements at its disposal to facilitate the settlement of the balance of payments difference during the early postwar transition period'.² In December 1943 a new British draft of the Joint Statement was transmitted to Washington. This introduced a section entitled 'Transitional Arrangements' the substance of which was later embodied in the final agreement, and which provided for a period of three years or more following the war during which members would not be required to accept the obligations of the fund regarding exchange restrictions. By the spring of 1944 agreement between the British and Americans was finally reached and the Joint Statement was published in April 1944.

In November 1943 there arrived in England White's proposal for an International Bank for Reconstruction and Development, not now so idealistic or far-reaching as when it had appeared in its original form in Rio de Janeiro,³ but carefully prepared and served to suit the delicate digestion of Congress. The proposed bank was to have a capital of \$10 bln subscribed by member governments and was designed to make loans for reconstruction and development purposes. At least 25 per cent of the capital was to be paid in gold. Loans were to be partly in local currencies and partly in international currency units, according to estimates of the portion of the loan to be spent at home and abroad. It was for some time thought in the American Treasury that the functions of the fund and the bank might be merged in one institution but this was later rejected. Throughout 1942 and 1943 the discussions were concerned with the fund and there was no discussion of the bank, but the matter was under close study in the United States Treasury. At the informal discussions in June 1943 Secretary Morgenthau informed the delegates that the stabilisation fund must be accom-

¹ On this important point Keynes gave guidance in a letter to the Chancellor of the Exchequer. The fund was described as a 'reserve resource, entirely passive, except in the more extreme contingencies where countries were running towards the limit of the facilities of the fund in one direction or another'. Quoted by Harrod, *op. cit.*, p. 570.

² Cf. *Joint Statement*, Cmd. 6519, p. 10, sec. 10, (i).

³ Cf. footnote on p. 127 above.

panied by an international bank and plans were being made towards this end. On September 4, 1943, Mr. Adolf Berle, Under Secretary of State in the State Department, sent to Harry White in the Treasury a proposal for an International Investment Agency which had been drawn up in the State Department. This proposed in some detail an international institution which would make loans to members for approved purposes. Fundamentally the proposals of the Treasury and State Departments were not very different. Both provided for an international agency with capital subscribed in gold or member currencies. Loans were to be made from its own resources or private loans could be guaranteed. The Treasury proposal, however, provided that each loan must be guaranteed by a member government — a proviso absent from the State Department version. Another point of difference was that the Treasury draft demanded that the proceeds of loans should be spent only in the country of the currency which was lent; in the State Department draft proceeds were to be freely transferable. This question of 'tied' loans became a matter of controversy in the technical discussions and representatives of the Export-Import Bank of Washington pressed for acceptance of the Treasury view. As will be seen later the eventual scheme was a compromise.

At the discussions on the fund in September 1943 the British were informed of the progress of the bank scheme and were given a copy of the latest draft. On November 24, 1943 the United States Treasury published a *Preliminary Draft Outline of a Proposal for a Bank for Reconstruction and Development of the United and Associated Nations*. This proposal was in its essentials the basis of discussions on the bank project at Bretton Woods.

In May 1944 President Roosevelt issued invitations to the 44 United and Associated Nations to attend a conference to be held at Bretton Woods, New Hampshire in July to discuss the proposed Monetary Fund within the terms of the Joint Statement and also to consider the proposal for an International Bank. In order to complete the work of preparation for the conference a preliminary meeting between the British and American delegates was held at Atlantic City from June 23 to June 30 at which a number of matters still outstanding between the two countries were discussed. The penalties which were to be inflicted upon a country altering its exchange rate without the authority of the fund were to be watered down so that such a country would not be expelled from member-

ship but would only be refused access to the fund's resources, pending discussion with the fund of the disagreement. A number of British suggestions on the World Bank project were also placed before the preliminary meeting and it became clear that at the forthcoming conference the establishment of such a bank would be considered side by side with the fund proposal. The British proposal was that only a small portion of the bank's capital, namely 20 per cent, would be paid and be available for loans. The remaining 80 per cent was to be a guarantee fund to be used, if necessary, in connection with the bank's guarantees of private loans or to meet other obligations of the bank. This suggestion was put forward by Keynes and received the immediate support of all the delegates including that of the United States.

The Conference opened on Saturday, July 1, 1944, with a speech by Henry Morgenthau, Secretary of the United States Treasury and lasted for three weeks. The list of 400 delegates was an impressive one including many names famous in the world of economics and finance, and many later to become known through the work of the Fund and Bank. The British delegation consisted of Lord Keynes, Professors Dennis Robertson and Lionel Robbins, Mr. (now Lord) Brand, Sir Wilfred Eady of the Treasury, Nigel Bruce of the Foreign Office, and Redvers Opie from the British Embassy in Washington. Besides Harry White the United States sent Henry Morgenthau and his successor-to-be F. M. Vinson, Dean Acheson and eight others. Canada had Abbot, Rasminsky and St. Laurent. France had Mossé and Mendès-France. Beyen was among the Netherlands group; Camille Gutt and Theunis spoke for Belgium. The Soviet Union sent a delegation of six. Denmark, which had no government in exile, was represented unofficially by her Minister in Washington. A number of already-existing international agencies such as the International Labour Office, UNRRA, the League of Nations and the United Nations Interim Commission on Food and Agriculture also sent observers.

The delegates and officials faced an agenda which, while lengthy, had been exhaustively worked over during the years of detailed planning which had preceded.¹ The smoothness and amity of the subsequent three weeks' proceedings were in great part due to the fact that the two leading participants had already reconciled their

¹ An exception to this was the plan for the bank to which much less prior attention had been given than to that for the fund.

differences and discussed the proposals with other leading powers. The main purpose, then, of the Conference was to generalise discussion of the proposals and set the seal of international agreement upon them. Nevertheless, it must not be supposed that the Conference was a mere formality. All the amendments (and there were many) proposed by the participant nations had to be considered and certain topics, such as the size of quota subscriptions, or the management and location of the fund, might have given rise to serious disagreement.

In order to carry out its work the Conference divided into three technical commissions upon which each delegation was represented. Commission I was to draw up the Articles of Agreement of the International Monetary Fund and was presided over by Harry White. Commission II, of which Keynes was the chairman, was to deal with the setting up of the World Bank. Commission III was to consider other means of international financial co-operation and was under the chairmanship of Dr. Eduardo Suarez of Mexico.

It is impossible to follow the work of the Conference in detail. Those who wish for more detailed information must seek it in the two volumes of the Proceedings and Documents of the Conference prepared by the United States Department of State¹ but one or two of the points discussed and certain special aspects of the Conference are worth a passing reference.

The deletion from the White Plan of the proposal to deal with the accumulated war-indebtedness of Great Britain was noticed by countries which had only now entered the discussions. Two countries, India and Egypt, pressed that a clause should be inserted in the articles empowering the Fund to deal with this problem. The plea of the Indian delegate, Mr. A. D. Shroff,² was spirited and he pressed his point on two grounds: first, that India, as a relatively poor, under-developed and over-populated country, had great need of capital goods and that multilateral convertibility of at least a part of India's blocked balances was necessary if she was to procure them; second, that it was illogical for the Fund as an organisation aiming at securing international equilibrium not to take under its control these 'billions of accumulated balances' the neglect of

¹ *Proceedings and Documents of the United Nations Monetary and Financial Conference*. United States Department of State 1948, 2 vols.

² Cf. *ibid.*, vol. II, pp. 1171-3.

which would 'be to create a sort of rival to the Fund' outside its jurisdiction. Mr. Shroff laid great stress on the strain which sterling balances would impose on the British economy, and it is evident from his speech that the Indian delegation looked to Fund control of the balances as the most likely, if not the only, solution which would result in India getting payment. Egypt, spurred by similar motives, echoed India's plea. The proposal, listed as an alternative was referred from Commission I to Commission III. It is unnecessary to trace its fortunes through the Conference labyrinth¹ but the positions taken by Britain and the United States are interesting. The United States delegate was obviously concerned only to preserve the *status quo* and he contented himself with the argument that 'the IMF would be overloaded if this item was included among the purposes of the Fund' and that 'the problem can best be settled directly by the countries concerned'. Clearly the United States delegation was not to be shaken and further pressure by Egypt and India served only to thicken the fog of abstract nouns surrounding the American explanation. The British approach to the problem was surprising and, in the light of subsequent events, unfortunate. Keynes, replying to the Indian delegate, gave the British view that 'the settlement of these debts must be, in our clear and settled judgement, a matter between those directly concerned. . . . We concur entirely in the view which has just been expressed by the American delegation that the Fund is not intended to deal directly with war indebtedness.'² So the British cast aside an opportunity to place the whole problem of accumulated war indebtedness on an international footing, believing it seems that in bilateral negotiations they could persuade their creditors to cancel all or a part of these debts which had been incurred during the common war effort.³

The Bank proposal, on which less preliminary work had been done, required careful consideration at Bretton Woods. The question of whether the emphasis of the Bank's activities should fall upon reconstruction or development was one point at issue and the arguments of countries which had suffered destruction of their

¹ Cf. *ibid.*, pp. 122, 278, 1168-70, 1171-3.

² Cf. *ibid.*, p. 1170.

³ The right of countries like Egypt to press their claims to debts incurred by Britain in the defence of those very countries has been questioned by many, including Mr. Churchill whose views as Prime Minister must have been an important factor in 1944.

national capital in war had to be weighed with those of the under-developed countries. The intention was that the Bank should place emphasis on both functions but no undertaking was embodied in the Articles. Controversy also settled around the question of the Bank's size and the allowable ratio of loans to assets. Keynes favoured a large scale and hoped too that the Bank would not be easily deterred from lending by the risk element, but American banking interests pressed for greater orthodoxy and were somewhat horrified at Keynes's heterodox argument 'that the Bank would not have discharged its duty if it had not dissipated its assets within ten years.'¹

Then there was the ticklish problem of the size of quotas. No formula for the calculation of the quotas is given in the Final Act of the Conference but it must be assumed that the formula was similar to that proposed in the White Plan.² Apart from the choice of formula it was impossible to divest the question of determination of quota from certain considerations of prestige and subjective ideas of relative importance. The Russian delegation, by a series of machinations,³ secured for their country a quota of almost equal size to that of Britain, in spite of the dependence of the latter and the independence of the former from foreign trade. China, then the beloved and pampered hope of American Asiatic foreign policy, was also given a large quota. The Russians caused some difficulty by refusing to allow their quota in the Bank to be the same as that for the Fund.⁴ Ultimately they relented, became less parsimonious and fell into line with other members.⁵

¹ Cf. Harrod, *op. cit.*, p. 580.

² The relevant provision in the White Plan reads: 'The quota for each member country shall be determined by an agreed-upon formula. The formula should give due weight to the important factors relevant to the determination of quotas, e.g., a country's holdings of gold and foreign exchange, the magnitude of the fluctuations in its balance of international payments, and its national income.' Cf. p. 5, sec. II (2). The quotas under the Keynes Plan were to be fixed by reference to the volume of the country's trade during three pre-war years. As one writer aptly says, the White Plan provided for an aristocracy of wealth while the Keynes Plan gave precedence to a nation of shop-keepers.

³ For an account see R. F. Mikesell's essay 'Negotiating at Bretton Woods 1944' in *Negotiating with the Russians*, ed. by R. Dennett and J. E. Johnson, 1953, chap. 4.

⁴ Clearly because the Fund quota entitled the member to a drawing right while the Bank quota was a liability for which the ultimate return was more difficult to see.

⁵ This is perhaps the point to comment on the Russian behaviour and attitude before and after Bretton Woods. A copy of the White Plan was given to the Russians early in 1943 and there were exploratory discussions with Soviet representatives. In June 1943 Soviet representatives took part in a three-day informal

Among the multifarious topics on the agenda of Commission III was a proposal by the Norwegian delegation that, at the earliest possible date, the Bank for International Settlements should be liquidated and that a Commission of Investigation should examine the record of management and the transactions of the Bank during the war.¹ This proposal was no doubt due to the widespread belief in the pro-German proclivities of the Bank, and to the belief that the Bank was harbouring German assets in neutral territory. The Netherlands delegation supported the Norwegian suggestion² and at one stage Committee 2 on Enemy Assets, Looted Property and Related Matters went so far as to recommend that membership of the Fund should be contingent on the Central Bank of that country taking 'the necessary steps to foster the liquidation of the Bank for International Settlements'.³ This drastic demand was, however, deleted at a later stage. The proposal that the BIS be liquidated as soon as possible was, however, passed by the plenary session and

conference of 19 countries at the United States Treasury. Important informal negotiations with the Russians did not begin until February 1944 when a series of conferences was held between a Soviet delegation headed by N. F. Chechulin, Assistant Chairman of the State Bank of the USSR, and an American technical group headed by White. The purpose of these meetings was to consider a draft of the Joint Statement and of the United States' proposal for a World Bank and to determine the Russian attitude to these proposals. The Russians, it was found, were not interested in the fundamental problems of the Fund. They wanted answers to four questions: what would it cost them to join; what would they get out of it in the way of credits; how much would Fund membership interfere with their internal and external economic practices; and what part would the Soviet Union have in the management of the Fund and Bank? In April 1944 Chechulin announced the Russian intention to be present at Bretton Woods and their agreement to the Joint Statement. The Russians were present at Atlantic City but did not play an active part. The Russian delegation at Bretton Woods was not obstructionist and Keynes refers to them as pleasant and likeable (cf. Harrod, op. cit., pp. 580-2) but they seem to have been exclusively concerned with what directly affected the USSR and never with the broader aspects of co-operation. Clearly they wished to get the most out of the Fund and put as little as possible in. An example of this was their attempt to reduce the gold subscription and to minimise the repurchase provisions. They also pressed for credits by the Fund to war-devastated and ex-occupied countries. Acceptance of the Bretton Woods Agreement was open to countries represented at the Conference until December 31, 1945. On December 29 representatives of 38 countries signed the Articles in Washington but the Russians did not appear. In response to a United States Government enquiry the USSR replied that it had not yet had time to study the proposals. Although at the Fund's first meeting at Savannah in March 1946 the Czech proposal that the period for participation should be extended to December 31, 1946 was adopted, the Russians did not come forward. They sent, on invitation, a low-ranking observer to Savannah, but he and his staff held frigidly aloof from the technical (and social) work of the Conference. Cf. *Negotiating with the Russians*, chap. 4; *The Soviet Financial System*, Mikhail V. Condoide, pp. 138-44.

¹ Cf. *Proceedings and Documents*, p. 330.

² *ibid.*, p. 915.

³ *ibid.*, p. 1191.

embodied in the Final Act.¹ In spite of all this the villain still lives.

It was to Commission III also that Australia submitted a resolution that members of the new IMF 'should be invited to accept concurrently an international agreement in which the signatories will pledge themselves to their own people and to one another to maintain high levels of employment in their respective countries and to . . . prevent the growth of unemployment and its spread to other countries.'² The Australian attitude at Bretton Woods was coloured by the experience of a primary-commodity producing country in the 'thirties and the delegation was concerned to know how, in the postwar world, the industrial countries proposed to maintain a high and stable level of income and demand for foreign products. The Australian delegate in the discussion on Article I made the following statement: 'In the opinion of the Australian delegation the purposes of the Fund, which provide criteria for its management, place too little emphasis on the promotion and maintenance of high levels of employment and too much emphasis on the promotion of exchange stability and on shortening the duration and lessening the degree of disequilibrium in international balances of payments.' In spite of the eloquent Australian pleas the proposal was defeated when voted on by Commission III.

Finally, on the question of the location of the headquarters of the Fund, Britain was at odds with the United States. Keynes's doubts of the wisdom of locating the Fund in the United States have already been referred to and although at the Conference Britain had to submit to the ruling that the Fund's headquarters should be in the country having the largest quota (cf. Article XIII, sec. I) she reserved her right to raise the matter again as a matter for direct discussion between governments.³

In three weeks the Conference, by herculean labours, completed the structure of the Fund and Bank and on July 22 Keynes moved the acceptance of the Final Act embodying the Articles of Agreement of these two bodies.⁴ Thus for the first time an international conference disbanded which had taken positive steps for

¹ Cf. section V.

² Cf. *ibid.*, pp. 279 and 834-7.

³ Cf. *United Nations Monetary and Financial Conference, Final Act and Related Documents*, Washington 1944, pp. 119-20.

⁴ *United Nations, Monetary and Financial Conference. Final Act*, Cmd. 6546 of 1944.

the world's monetary betterment. Whatever the delegates may have felt as they took their homeward ways this was no Brussels or Genoa; here the United States had acted constructively and led the Conference in its work. How different from the fiasco of 1933 when the refusal of her support and leadership had counted for so much. Yet to those who had laboured for so long on both sides of the Atlantic to bring their plans to fulfilment the final result must have been disappointing. The more visionary of the two plans had perished, and from the other had been painstakingly expurgated all of vision, daring or experiment which to little men might have smacked of revolution. Before them was to be placed a document which might find favour in the 'bright dead alien eyes' of Congress. Whether it was 'to become the pivot of the future economic government of the world' seemed now of scant importance.

To the returning delegates the future of the newly-born institutions must have loomed large and their minds must, rightly, have been filled with the problems which these were to face in their formative period. Now, after more than a decade, one cannot but feel that the establishment of these bodies was overtopped in importance by the establishment at the Conference of certain principles, the recognition of which has done more to shape subsequent events than the institutions in which they were embodied. The principle of partial responsibility of the creditor nation has underlain American foreign economic policy since 1944 and has enabled formidable problems to be valiantly met. The establishment of the principle of multilateral trade, convertible currencies and non-discrimination has also had its influence on events — not always so happily. Finally, the standards of international monetary conduct which underlay the Bretton Woods Agreement have, in the main, been honoured by the participants and, if the number of international monetary and economic bodies which has arisen is the arbiter, the precedent of international organisation has been followed.

THE BRETTON WOODS SYSTEM

THE Conference of July 1944 established the outlines of the international monetary scene as we have known it since the war — of the so-called Bretton Woods system. Without embarking upon a laborious study of the Articles of the Fund and Bank we must attempt an evaluation of the model which was constructed at Bretton Woods. Later, when we shall have examined the working of the model over ten years, we may be in a position to form useful judgements.

Bretton Woods created two international institutions — an international stabilisation fund and an international investment authority. Implicit in the organisation and structure of these institutions were certain principles as to how international trade and payments should be conducted. These we must regard as the essence of the Bretton Woods system. The institutions were designed to give expression to these principles, and, given the validity of the principles, the institutions could sooner or later have been perfected, if not in the first drafting then by a series of adjustments made in the light of experience. In the interests of clarity it is perhaps best to discuss briefly the nature and validity of these basic principles and in doing so to touch upon the machinery which has sought to give them expression.

The basic principles of the Bretton Woods system are as follows:

(i) That exchange rate changes are a matter of international concern and that exchange stability is best achieved by a system of exchange rates which are fixed in the short-run but may be varied from time to time to adjust fundamental changes in the international economy.

(ii) That there must be some augmentation of national gold and currency reserves in order that countries are not forced to meet short-run balance of payments deficits by disturbing domestic adjustments of income and employment.

(iii) That the interests of political harmony and economic welfare are jointly served by a system of unfettered multilateral trade and convertible currencies.

(iv) That a balance of payments disequilibrium is necessarily two-sided and its correction is the joint responsibility of both surplus and deficit countries.

(v) That international monetary co-operation is best effected through an international agency with defined functions and powers.

(vi) That monetary disturbances are frequently non-monetary in origin so that an international monetary agency must co-exist with other agencies each responsible for such problems as employment stabilisation and the liberalising of world trade.

(vii) That a high and sustained level of international investment is necessary for the stability of the international economy and that the flow of private international investment may be facilitated and increased by the creation of an international investment bank.¹

(i) The principle that exchange rate adjustment was a matter of international concern was generally accepted by all of the Bretton Woods nations. The confusion of the international economy during the interwar period and the competitive depreciation of the 'thirties was in itself a sanction for agreement upon international control of exchange rates. But upon the nature of the postwar exchange rate structure there was not agreement. The old battle of free or fixed exchange rates was joined once more and the outcome, the system of managed flexibility, was the compromise result — a system seeking the best of both worlds.² The elements of the Fund's exchange rate policy are to be found in Article IV. The par values of all member countries' currencies were to be defined in gold terms thus fixing the exchange rates between the currencies. Exchange dealings must be carried on at rates which do not vary, as between maximum and minimum in the case of spot transactions, by more than one per cent. Each member undertakes to promote exchange stability and

¹ Discussion of the role of international investment and the work of the IBRD will not be dealt with in this chapter. It forms the subject of chapter 8.

² In one of the Reports of Committee 2 on Operations of the Fund to Commission I the following passage occurs: 'There was a long controversy on the very familiar topic Rigidity vs. Stability. Probably neither of the adherents have changed their minds during our discussion, but most of them are almost willing to end the twenty-year war by a compromise.' Cf. *Proceedings and Documents*, p. 312.

to propose a change in the par value of its currency only when it is necessary to correct a fundamental disequilibrium. If the proposed change is not to exceed 10 per cent of the initial par value the Fund shall allow the change and if, in the case of a further change it does not exceed a further 10 per cent it must 'declare its attitude within 72 hours if the member so requests'. The nature of a 'fundamental disequilibrium' is not revealed so that the criteria according to which the Fund will, or will not, allow a devaluation are not known. In view of the difficulty of giving one firm criterion this vagueness is probably intentional.¹ In settling upon this compromise system of exchange management the authors robbed Bretton Woods of any claim it could have had to be a system of international adjustment. If, as was assumed,² the Fund eschewed control over national monetary policies, and if, as is also implicit, countries refrained from policies which aimed at adjustment of their external balances by deflation of their domestic income and cost structures, then the whole burden of adjustment was thrown upon the exchange rate. Fixing the rate ensured that no automatic corrective mechanism would be at work to prevent deficits or surpluses from accumulating until they reached crisis level.³ Under the arrangement where a parity is only changed to meet a 'fundamental disequilibrium' the disequilibrium is *ipso facto* in existence by the time action is taken to correct it. Measures for the restoration of international equilibrium must be timely and should serve to counteract disequilibrium as it arises. The Fund was intended to deal with short-run disequilibria in the balance of payments which it tacitly assumed to be temporary and self-correcting phenomena. In fact it provided no adjustment process whatever for these and its exchange rate changes

¹ Cf. p. 97 above. R. F. Mikesell, who, we are told, 'had access to the unpublished minutes of the pre-Bretton Woods meetings', tells us that 'the principal criterion for rate alterations in the minds of the authors of the text of the Fund Agreement was the existence of a disequilibrium in the current international accounts of the members requesting a change'. Cf. R. F. Mikesell, 'The Rôle of the International Monetary Agreements in a World of Planned Economies', *Journal of Political Economy*, December 1947; cf. also Alvin H. Hansen, 'Fundamental Disequilibrium', *Review of Economic Statistics*, 1946 and G. Von Haberler, 'Currency Depreciation and the International Monetary Fund', *Review of Economic Statistics*, 1946.

² Cf. *Final Act*, p. 16, Article 1.

³ The argument has been well put by *The Economist*: 'If there is to be a crises-proof system of international trade it will have to include some such "thermostatic" control. And if the nations are not prepared to move back to the gold standard and submit their domestic policies once more to its disciplines, they will have to move in the direction of much more flexible exchange rates.' Cf. 'Freer Trade in Europe', *The Economist*, October 31, 1953, p. 316.

in response to a 'fundamental disequilibrium'¹ were suited to deal only with long term problems.

(ii) The logical implication of this was that the liquid international reserves of individual countries should be augmented by allowing them access to an international pool of currencies, to which, in emergency, they might have recourse until, by some means unspecified, the balance of payments was adjusted. But to leave this pool exposed to the demands of countries whose imbalance might continue, and for the correction of which there was no specified provision, would have been to invite disaster. Inevitably countries would tend to postpone the painful process of adjusting their own external balances until the Fund could supply them no longer. For this reason there could be no question of automatic access to the Fund's resources. Had such access been automatic the absence of any adjustment process would have carried with it the corollary of very large balances held available by the Fund.

The pool of currencies held by the Fund was subscribed by members according to a quota system,² the size of the quota determining not only the size of the member's contribution and drawing rights but also its voting rights and share in the government of the Fund. A part of the quota was to be paid in gold and the remainder in the currency of the member.³ Each member was to have the right to purchase from the Fund, in exchange for its own currency, the currency of another member up to a maximum of 25 per cent of its quota per annum, and only to the extent that the total holdings of the Fund in that currency did not exceed 200 per cent of its quota.⁴ Thus a member country has in effect drawing rights on the Fund in currencies other than its own up to the full amount of its quota. These drawing rights are, however, far from automatic, but are subject, under the Articles to the following conditions:

- (a) the Fund's resources may not be used to meet a large or sustained outflow of capital;
- (b) the Fund may deny the use of its resources to any country making an unauthorised change in the par value of its currency;

¹ Cf. *Final Act*, p. 19, sec. 5.

² The five largest quotas were: United States — \$2,750 mln; United Kingdom — \$1,300 mln; China — \$550 mln; France — \$450 mln and India — \$400 mln.

³ Each member was to pay in gold the smaller of (i) twenty-five per cent of its quota, or (ii) ten per cent of its net official holdings of gold and dollars on March 1, 1947; cf. Article III, sec. 3 (b).

⁴ Cf. Article V, sec. 3 (a) (iii).

- (c) the Fund shall not have declared the requested currency to be 'scarce';
- (d) the Fund must be satisfied that the currency requested is presently needed for making payments which are consistent with the provisions of the Fund Agreement;
- (e) a member shall not be entitled, without the Fund's permission, to acquire currency to hold against forward exchange transactions;
- (f) 'the Fund may postpone exchange transactions with any member if its circumstances are such that, in the opinion of the Fund, they would lead to use of the resources of the Fund in a manner contrary to the purposes of this Agreement or prejudicial to the Fund or the members.'

These are far-reaching conditions and give to the Fund the position of final arbiter upon all requests for accommodation. The Fund from its inception took the view that, with its limited resources, it could provide only temporary assistance and for that reason, and in order that the Fund might not become choked with large holdings of soft currencies, provision was made (Article V, sec. 7) for the repurchase by a member with gold or convertible currencies of its own currency held by the Fund in excess of its quota. There was to be an obligation for members to repurchase their currencies annually up to an amount computed according to a formula which gave weight to the increase in the Fund's holding of the member's currency and to any increase which had occurred in the country's national reserves.¹ Members purchasing foreign exchange from the Fund with their own currencies are required to pay on each purchase a uniform service charge of one half of one per cent. If a member's purchases from the Fund raise the Fund's

¹ A member's monetary reserves include the member's net official holdings of gold and convertible currencies, the latter being currencies of members of the Fund that have not taken advantage of the special transitional arrangements to impose limitations upon their use. The only currency of standing in this group is the dollar. The repurchase provisions were designed to give effect to three basic principles:

- (i) countries holding reserves should not make use of and deplete the Fund's stock of gold and hard currencies;
- (ii) countries whose reserves are increasing should devote part of the increase to replenishing the Fund's stock of gold and hard currencies;
- (iii) countries who carry on their foreign trade with the help of key currencies must not accumulate large balances of such currencies by purchasing them with their local currencies.

For an excellent discussion of the efficacy of the Repurchase Provisions see Wm. Adams Brown, Jr., 'The Repurchase Provisions of the Proposed International Monetary Fund', *American Economic Review*, vol. 35, 1945.

- holdings of its currency above its quota additional charges are levied by the Fund on that country's holdings in excess of its quota. These charges are progressive in accordance with the following scale and unless a member's monetary reserves are less than half its quota all the charges are payable in gold.¹

SCHEDULE OF CHARGES ON USE OF FUND RESOURCES

Charges on Fund Holdings of a Member's Currency In Excess of the Member's Quota

					<i>Charges for each Period in Which Fund Holdings of a Member's Currency Exceed its Quota by:</i>		
					<i>0-50</i>	<i>50-75</i>	<i>75-100</i>
					<i>per cent</i>	<i>per cent</i>	<i>per cent</i>
					<i>(Per cent per annum excluding service charge)</i>		
0 to 3 months	-	-	-	-	0.0	0.0	0.0
3 to 6 months	-	-	-	-	2.0	2.0	2.0
6 to 12 months	-	-	-	-	2.0	2.0	2.5
1 to 1½ years	-	-	-	-	2.0	2.5	3.0
1½ to 2 years	-	-	-	-	2.5	3.0	3.5
2 to 2½ years	-	-	-	-	3.0	3.5	4.0 ^a
2½ to 3 years	-	-	-	-	3.5	4.0 ^a	4.5
3 to 3½ years	-	-	-	-	4.0 ^a	4.5	5.0 ^b
3½ to 4 years	-	-	-	-	4.5 ^b	5.0 ^b	
4 to 4½ years	-	-	-	-	5.0 ^b		

a. Point at which consultation between Fund and member becomes obligatory.

b. Maximum charges. Fund has discretion to make lower charges.

Source: Annual Report of the IMF for 1954, Appendix II, p. 136.

The progressive nature of these charges makes it clear that they are intended to act as a deterrent to countries against making large or prolonged use of the Fund's resources. When the rate payable by a member on any amount or for any period of time reaches 4 per cent the member must consult with the Fund with a view to reducing the Fund's holding of the member's currency.

The Fund's whole function so far as the supply of additional liquidity is concerned has been construed by its policy makers to be the supply of temporary accommodation. It is thus tacitly

¹ The table shows the charges resulting from transactions after January 1, 1954 and still in force. For earlier transactions two earlier schedules of charges apply.

assumed that balance of payments disequilibria are temporary phenomena. Since the Fund has no real authority over the policies of member governments the assumption is also that they are self-correcting. Neither assumption is of course correct. In practice it is clear that the Fund hoped that the very paucity of its resources and the fact that they are not automatically available would drive member nations still to order their domestic policies with some consideration for the needs of external balance. 'The Fund has emphasised to members that the purpose of the use of its resources is to give members time to make necessary adjustment and not to avoid the necessity of such readjustments.'¹

In order that the size of the total Fund pool could be adjusted to changing conditions provision was made (Article III, sec. 2) for a quinquennial review of quotas and for their revision subject to the approval of a four-fifths majority of total voting power. The only interim provision for adding to the pool was in the case of a currency becoming scarce with the Fund, when the Fund was empowered to replenish its holding of the scarce currency by borrowing from the member — providing of course the member was willing to lend. In fact the subscriptions made under the quotas were to be regarded as once-for-all payments and, for practical purposes, the size of the Fund was thus determined at the outset.² That it was inadequate was generally agreed. It was the more so in view of the inflexibility of exchange rates and the secondary role to which they had been relegated in the Fund model of international adjustment. Moreover, apart from the inadequacy of the size of the pool as a whole there was also the fact that the Fund's holding of a given currency might be insufficient to meet the demands made by deficit countries for that currency. In the case of a chronic creditor country demand would concentrate upon the currency of the creditor and unless the Fund's holding were very large it would not be able to sustain the demand for long. The provision which the Fund made to deal with this situation is discussed in (iv) below.

(iii) The principle of multilateral trade and payments and of non-discrimination, in short the denial of the right of external balance adjustment by direct controls, was central to the Bretton

¹ Cf. *Annual Report of IMF*, 1948, pp. 46-7.

² It amounted in all to \$8,800 mln in 1944 at the time of the Conference. The figure at April 30, 1956 (allowing for the non-participation of the USSR and the admission of a number of other countries not represented at Bretton Woods) was \$8,750.5 mln.

Woods system¹ and was embodied in certain provisions in Article VIII. No member was to impose, without the approval of the Fund, restrictions on the making of payments and transfers for current international transactions. No member was to engage in any discriminatory currency arrangements or multiple currency practices unless with the approval of the Fund² and all currencies were to be freely convertible into one another at official rates. It was, however, recognised that in the abnormal payments conditions which would follow the war it might be necessary for countries to maintain controls and to discriminate against their creditors. For this reason the Agreement provided (Article XIV) for the gradual dismantling of controls over a period of five years. Each member was, at the outset, to inform the Fund if it proposed to avail itself of these transitional arrangements. Three years after the date on which the Fund began to operate (March 1, 1947) it was to report on the restrictions still in force and continue such reports as long as necessary. If, after five years, a country still retained direct controls it was to consult with the Fund as 'to their further retention' and, if, in the face of Fund requests for their removal, it still retained controls, it might be declared ineligible to use the resources of the Fund. To these provisions for the re-establishment of multilateral trade the Americans attached great importance believing such re-establishment to be a main *raison d'être* of the Fund, equal in importance to its stabilisation functions. As we shall see the virtual aloofness of the Fund from postwar balance of payments problems, the passing into other hands of the measures designed to deal with these, and the dominance of American opinion in the formation of Fund policy, have all served to shift the emphasis of the Fund's purpose from that originally intended at Bretton Woods and place it upon this liberalising mission.

But here again we find that the intention is not backed by suitable machinery. The failure of the Fund to provide a mechanism of adjustment is in itself a powerful force making for the continuance

¹ In the eyes of the Americans the re-establishment and maintenance of multilateral trade was the main task of the Fund. The following is an extract from an article by Harry White: 'Primarily, the Fund is the means for establishing and maintaining stability, order and freedom in exchange transactions. The resources of the Fund are only for the purpose of helping countries to adopt and keep such policies.' Cf. 'The Monetary Fund: Some Criticisms Examined', *Foreign Affairs*, January 1945.

² There exists here the important exception of permissible discrimination by debtor countries against the imports from a surplus country whose currency has been declared scarce by the Fund. See p. 157 below.

of discrimination and controls. A country suffering a deficit in its external balance, denied short term adjustment through exchange rates by the Fund system, and precluded from adjustment through income and cost variation by its own determination to provide full employment, will, in order to protect its reserves, fall back upon the sole remaining adjustment factor, direct control over the items of its balance of payments.

The determination of the Fund to bring about multilateral trade carried with it the necessity to provide a real adjustment mechanism. The proposed condition eventuated as one in which the Fund was trying to deny both methods of adjustment simultaneously and then holding up a warning finger as countries turned to the only path left to them. There is no reason, in theory, why a real adjustment mechanism could not have been written into the Fund's constitution in the form of allowance for flexible rates of exchange and agreed principles for the international supervision of their movements. In fact the reason why this was not done was that there existed from the 'thirties the association of flexible rates of exchange with competitive depreciation, yet there was little reason to fear the recurrence of this in the postwar period¹ and means could in any event have been devised and embodied in the Fund to prevent it.

(iv) The Fund Agreement recognises that a sustained surplus in the balance of payments of a leading member country, accompanied by deficits in the balances of several other countries, is a threat to the stability of the Fund and to the world economy. Such a condition is met in the Agreement by the various Scarce Currency provisions, all of which recognise that such a disequilibrium is two-sided and that its removal is the joint responsibility of both surplus and deficit countries.² These measures are 'designed to help member countries to maintain stable and orderly exchange arrangements during a period of serious distortion in the pattern of international payments while they adopt corrective measures in harmony with the purposes of the Fund'.³ The scarce currency

¹ Cf. p. 90 above.

² The scarce currency condition must be clearly distinguished from other types of disequilibria. Clearly the currency which is scarce must be a key currency since the fact that it is scarce implies a widely pervasive demand for it. Moreover this type of scarcity must be clearly distinguished from the general shortage of foreign currencies experienced by a country having a persistent deficit in its balance of payments.

³ Cf. E. M. Bernstein, 'Scarce Currencies and the IMF', *Journal of Political Economy*, March 1945.

provisions are of two types; those which seek to prevent a currency becoming scarce; and those which are designed to deal with scarcity if it arises. Of the first type the measures are not grouped in a single clause of the Agreement but are scattered among its various sections. There are four main protections. Firstly, the Fund had the power to refuse approval to a par value whose maintenance might involve 'recourse to the Fund . . . on a scale prejudicial to the Fund and to members'. (Article XX, sec. 4 (b).) Secondly, the provision for changes in par values permits a change in the parity of a currency if it is agreed by the member and the Fund to be the appropriate measure to deal with scarcity or potential scarcity. And thirdly, the Fund may inform a member of potential scarcity of its currency and recommend appropriate action. These preventive measures are of problematic value. The Fund's right to refuse approval of the submitted par value was a once-for-all measure which passed with the certification of all submitted par values in December 1946, while the other measures were such as would only be invoked when scarcity had already in some degree revealed itself. It is the second set of measures, those designed to deal with *de facto* scarcity, which are most important. These are embodied in the so-called Scarce Currency Clause — Article VII.

The scarce currency clause embodies the principle of the joint responsibility of surplus and deficit countries for disequilibrium. As soon as it becomes evident to the Fund that the demand for a member's currency threatens the Fund's ability to supply it the Fund shall formally declare the currency scarce and ration the residual supply with regard to the needs of members and to the general international economic situation. The Fund may seek to meet the scarcity by requiring the member concerned to sell its currency to the Fund for gold and all members undertake to buy gold offered to them by the Fund if it is in need of their currencies. Alternatively, the Fund may borrow the scarce currency from the member concerned, but no country is obliged in such circumstances to lend, for in the last resort the commitment of any country is limited to its quota subscription to the Fund.

If a formal declaration of the scarcity of a currency is made by the Fund it shall operate as an authorisation to any member,¹ after

¹ It is in fact necessary for all countries, deficit and surplus, to impose such restrictions. If the surplus countries do not impose restrictions, deficit countries could import via non-deficit countries from the scarce-currency country. There is, however, some doubt as to whether the scarce currency clause can be inter-

consultation with the Fund, temporarily to impose limitations on the freedom of exchange operations in the scarce currency.

The recognition of joint responsibility was a constructive step. Hitherto much of the onus of correction had devolved upon the deficit country on whom action would be forced by the dwindling of its gold and foreign exchange reserves. Such action might well involve a voluntary deflation of income and prices and be at the cost of a measure of unemployment in the deficit country. Now, action was to be forced upon the surplus country which, on pain of having other countries discriminate against its exports, would be driven to attempt a reduction of its surplus either by a domestic expansion of income, by reduction of tariff barriers or by a programme of long-term overseas investment. Particularly would this measure be useful in the case of a surplus arising in a country suffering from recession. If corrective measures were, in such circumstances, forced only upon the deficit countries the result would be to generalise the recession. Under the scarce currency clause the recession would tend to be sealed off in the surplus country, there to be attacked by appropriate domestic policies.¹

The scarce currency clause was regarded in 1944 as an admission by the United States that the European countries were entitled to some protection from the effects of a postwar scarcity of dollars. Indeed it was argued that it committed the United States to direct preventive action since she would undertake such action rather than see her exports barred from European markets. The events of the last ten years and the liberal flow of American aid to Europe has proved the optimism to have had foundation. Yet it must be remembered that throughout the postwar years dollar scarcity has been accompanied by full employment in the United States. It remains to be seen how that country will react to discrimination against its exports when it is suffering domestic unemployment.

preted in this multilateral sense. In Article VII, sec. 3 (b) it is stated that limitations on the freedom of exchange operations in a scarce currency 'shall be no more restrictive than is necessary to limit the demand for the scarce currency to the supply held by or accruing to the member in question'. The obvious interpretation of this clause is that the Fund shall have power to declare A's currency as scarce to B only, and that the scarce currency clause may work bilaterally. If so this is a serious defect.

¹ Some contractionary influences would inevitably be felt in the deficit countries as demand for their exports to the surplus country fell. The extent of the influence would depend upon the speed and facility with which the redundant factors in the export industries could be transferred to industries producing for the home market.

There should be no delay in declaring a currency scarce when the occasion arises. Experience has shown that with small relative changes in the national incomes of countries there can be wide swings in external balances. If the relief afforded by the scarce currency clause is to be effective it must be prompt and, while the decision to make a formal declaration of scarcity must be at the Fund's discretion, it must err, if at all, on the side of readiness. No determining principles are laid down in the Fund Agreement,¹ but Mr. E. M. Bernstein, who made a notable contribution to the technical aspects of the Fund's structure at Bretton Woods, has given us his views upon the way in which the clause should be implemented.² A scarcity would occur in two phases. In the first it would become recognisable by a large, persistent, and widely pervasive surplus in the external accounts of a single country. The deficit countries would soon experience a shortage of this country's currency and seek to augment their supply by purchasing it from the Fund. The second phase would begin when the Fund's holding of the scarce currency became endangered. Thus the point at which the Fund declares the currency to be scarce is important. It must clearly do so long before its own holding of the currency is exhausted, but in general the stage at which the declaration is made must depend upon the size of the members' deficits and upon the size of the Fund's holding of the scarce currency. Once the declaration is made the Fund will proceed to ration the scarce currency to members in accordance with their needs and the nature of the economic situation. If we assume that dollars be the scarce currency, the Fund would have an amount to ration made up of the balance of its dollar holding plus dollars received under repurchase obligations plus dollars paid in respect of its charges for interest. If the scarcity were of short duration (as if it were the result of a mild recession in the surplus country) demands for the surplus

¹ One defect of the Scarce Currency Clause is that for the Clause to be invoked the 'Fund's ability to supply that currency' must be seriously threatened. It may well occur, however, that while a currency is scarce in the world at large, the countries to whom it is scarce may be ineligible to use the Fund's resources, so that the Fund's ability to supply the currency is not threatened. This, of course, has happened in the case of the dollar. Since 1948 the Fund debarred members in receipt of ERP from purchasing dollars from the Fund so that small demands were in fact made for dollars. The dollar has never been formally declared a scarce currency although its scarcity has been general, acute and prolonged. By variously interpreting the rulings of the Clause the Fund may then be in a position to avoid its consequences and defeat its purpose.

² Cf. E. M. Bernstein, 'Scarce Currencies and the IMF', *Journal of Political Economy*, March 1945.

country's currency would soon cease, the Fund's holding of the scarce currency would increase as the repurchase obligations were met, and the Fund would assist in the general recovery by revoking the declaration of scarcity. Such interludes of scarcity are to be expected in a world subject to cyclical fluctuation and the existence of the Fund would soften the impact of the disequilibrium in two ways: it would provide formal principles for the imposition of restrictions against the surplus country and it would provide liquidity to ease the currency shortage and postpone the necessity to correct the external deficit by domestic deflation. These are worthy contributions. It should be noted, however, that the Fund does not provide any measures for meeting disequilibria due to long and severe depressions in income. It removes from the shoulders of members the necessity of responding to an unfavourable balance by an immediate policy of deflation, but it leaves the task of fighting income fluctuations to the governments of member countries. For this reason the Fund, which is an international short-term adjustment mechanism, requires to be augmented by a formal scheme for international anti-cyclical policies.

(v) and (vi) The Bretton Woods Agreement proposed to 'promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems'.¹ The membership of the institution was to be open to all of the governments attending the Conference and 'the governments of other countries at such times and in accordance with such terms as may be prescribed by the Fund'.² The Fund was to be an independent body but it was to co-operate 'with any general international organisation³ and with public international organisations having specialised responsibilities in related fields'. Thus, it was originally conceived that the Fund would form an integral part of a global programme of economic co-operation in which a number of functional agencies would operate side by side under the general co-ordination of the United Nations. It was intended that, while the Fund would be concerned with balance of payments and exchange problems and the Bank with long-term international investment, an organisation should be

¹ *Final Act*, Article 1, p. 16.

² At April 30, 1956 there were 58 members of the Fund including the former enemies; Germany, Austria, Italy, Japan and Finland. Other additions to the list were Burma, Ceylon, Pakistan, and Sweden.

³ In practice the United Nations.

created to govern the conditions under which trade is carried on, and that steps should be taken to promote international plans for full employment through the Economic and Social Council of the United Nations.

In Article I of the *Final Act* of the Bretton Woods Conference it is laid down that one of the purposes of the Fund shall be 'to facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy'. From the first of these aims sprang the Havana Charter and the plan for the creation of an International Trade Organisation; from the second sprang the various plans which have been prepared by the United Nations *ad hoc* committees for the promotion of international measures for full employment. The Havana Charter was not ratified by the main governments concerned and the projected ITO was never proceeded with. By this the IMF was robbed of one of its ancillary institutions and thereby weakened. It is outside the scope of this book to consider the Havana Charter and the ITO plan. The measures for international full employment will be discussed in Section V.

The provisions for the organisation and management of the Fund¹ provide for its management by a Board of Governors to which one governor and one alternate are appointed by each member country — each individual to serve for five years and to be eligible for re-appointment. Normally this board meets once a year, this constituting an annual meeting. It retains in its hands many of the most important powers of management such as the admission of a new member, the revision of quotas, election of directors, and the approving of a uniform change in the par value of the currencies of all members.² To the Executive Directors is given the daily conduct of the general operations of the Fund. These Directors were to be at least twelve in number and were to be appointed as follows:

(i) Five shall be appointed by the five members having the largest quotas; (the United States, Britain, China, France and India);

¹ Cf. Article XII, p. 28.

² In the absence of any specific ruling we must assume that approval of a unilateral change of parity devolves upon the Executive Directors, but in this as in many other important matters the Board of Governors would be the final arbiters.

(ii) If not already included under (i) the two members, the holdings of whose currencies by the Fund have been, on the average over the preceding two years, reduced below their quotas by the largest absolute amounts (in gold terms) shall be entitled to appoint a director;

(iii) Five shall be elected by the members (other than the American Republics) not entitled to appoint directors and,

(iv) Two shall be elected by the American Republics not entitled to appoint directors.¹

For the elective directorships elections should be conducted at two year intervals. Each director whether elected or appointed was to appoint an alternate with power to act for him in his absence. The Executive Directors were to function in continuous session at the principal office of the Fund in Washington. The Executive was to be completed by a Managing Director who was not to be a Governor or an Executive Director. This official was to act as chairman of the executive directors and as head of the Fund's operating staff.

Voting power on the Board of Governors and the Directorate was *pro rata* with the size of the member's quota, each member having 250 votes plus one additional vote for each part of its quota equal to \$100,000. When voting was required on the waiving of conditions applicable to the granting of an application by a member for use of the Fund's resources, or on the eligibility of a member to have access to those resources, the voting formula was more complex being designed to give more voting power to surplus countries.² On the basis of this formula the normal vote of the five principal members was as follows: United States 27,750, United Kingdom 13,250, China 5,750, France 5,500,³ and India 4,250. Thus the United States had 27.93 per cent of total voting power, the United Kingdom 13.33, China 5.79, France 5.54 and India 4.28. If the Article V formula were applied the voting power of the United States would be still greater.

¹ Condensed from Article XII, sec. 3, p. 29.

² The voting formula can be summarised as follows:

(a) General formula — Member's vote = $250 + \frac{X}{100,000}$

(b) Voting on Art. V, sec. 4 or 5 —

$$\text{Member's vote} = 250 + \frac{X}{100,000} + \frac{Y}{400,000} - \frac{Z}{400,000}$$

where X = member's quota in United States dollars; Y = net sales of its currency to date, and Z = net purchases of other currencies to date.

³ This is computed on the basis of France's revised quota.

From all of this it will be evident that the management of the Fund was to be political rather than technical; that governors and directors were to regard themselves as political delegates rather than contributors to a pool of technical knowledge; and that the largest contributor to the Fund had secured for itself a dominant role in policy and decision making. Such a set-up could scarcely fail to undermine the international character of the Fund and help to make it a sounding board for divergences of political (rather than economic) opinions upon international economic problems. Add to this the location of the Fund's offices in Washington and it will be clear that Keynes's fears for the future of the Fund as an international rallying ground for the best technical opinion on international monetary matters were well founded.

So far as the Fund's international status was concerned it brought no serious interference with national sovereignty. Members were expected to submit to the rules of the new international economy—to maintain stable exchange rates, to discard foreign trade controls, and to accept the Fund's advice on certain courses of action, but none of the prerogatives which national governments claim, such as the right to determine their exchange rate or to control domestic credit and fiscal policy, were to pass to the Fund. It could scarcely be argued that the Fund had over-riding international authority. Indeed it is arguable that it had not enough authority, still less the sanctions to enforce it. In any clash between the external and internal economic interests of members it would be the former which would go by default leaving the Fund to advise, cajole or threaten—not very convincingly. Within its membership and in its government it had to reconcile the interests of old countries and new, great and small, debtor and creditor. Was it to rule by moral force born of growing prestige and influence as a truly international agency? That seemed its great chance. But it was decided that it should rule by a paternalism born of the overwhelming influence of one member on its policies and management.

CHAPTER 7

MANAGED FLEXIBILITY IN ACTION

I

ON December 27, 1945 the International Monetary Fund and the International Bank for Reconstruction and Development were formally established when representatives of 30 countries took part in a signing ceremony in Washington. By the end of the year 35 countries had notified their membership¹ and of the nine countries remaining which had attended Bretton Woods five joined later. New members were also admitted from countries originally outside the United Nations. Italy became a member in 1947, Germany and Japan in 1952. Poland ceased to be a member in 1950. By April 1956 the total membership was 58 and the aggregate of quotas \$8,750.5 mln.

As soon as the Agreement entered into force each member appointed a governor and the Government of the United States, as the country having the largest quota, called the first meeting of the Board of Governors of the Fund to meet jointly with the Board of Governors of the World Bank at Savannah, Georgia on March 8, 1946. This inaugural meeting was important for during its ten days much of the preliminary organisation of the Fund was settled. By-laws were adopted to establish procedure for meetings of the Board of Governors, to settle the terms of service and remunerations of governors and alternates, and to control certain aspects of operations. It was intended that these by-laws should supplement the skeleton of the Fund Agreement. A temporary secretary was appointed who, after consultation with the Executive Directors, was to make all arrangements necessary for their first meeting in

¹ Altogether four of the 44 nations originally at Bretton Woods did not join the Fund — Haiti, Liberia, New Zealand and USSR. Poland withdrew in March 1950. Czechoslovakia stayed on as the only Eastern European country, but as a result of certain infringements she was, in November 1953, declared ineligible to use the Fund's resources.

May 1946 in Washington. At this meeting on May 6, the Executive Directors selected as their Managing Director, M. Camille Gutt of Belgium, who from that date assumed the chairmanship of the Executive Directors and the responsibility for organising and directing the staff. By September the appointment and organisation of the operating staff was complete¹ and the Fund was established as a corporate institution.

The next step was to establish the initial parities of exchange for member currencies. On September 12, 1946 the Fund requested each member 'to communicate within thirty days the par value of its currency based on the rates of exchange prevailing on October 28, 1945 — the sixtieth day before entry into force of the Agreement'.² On December 18, 1946 the Fund announced the certification of the par value of 32 of its then 39 members — the other seven postponing submission of their parities to a later date. The initial par values were, in all cases, those which had been proposed by members and were based on existing rates of exchange.

On December 19, 1946 the Fund announced that it would be ready to begin exchange transactions on March 1, 1947 and that the subscriptions of members, for whose currencies par values had been agreed, accordingly became payable by that date. By March 1 subscriptions had been received from members eligible to use the Fund's resources, accounting for not less than 65 per cent of the aggregate quotas set out in Schedule A of the *Final Act*. The total amount of subscriptions paid by June 30, 1947 was \$6,535 mln and the amount to be paid was \$51 mln. With regard to the gold part of the subscription, by June 30, 1947, 19 members had paid that part of their subscriptions payable in gold on the basis of 25 per cent of quota, while 11 had paid in gold on the basis of 10 per cent of their declared net official holdings of gold and United States dollars on September 12, 1946.

The date on which the Fund announced its intention to commence its exchange transactions, viz., March 1, 1947 served also to fix the so-called transitional period of five years, which was thereby due to end on February 29, 1952.

¹ The staff was divided into five departments: Operations, Legal, Research, Office of the Controller and Office of the Secretary. Each department was to have a director and was in turn divided into sub-divisions. Approximately 100 persons were initially recruited from 15 countries.

² Cf. Cable to member governments quoted in the *First Annual Report of the IMF*, p. 16.

The inaugural meeting of the Fund at Savannah did not prove to be the pleasant party that some had anticipated. The chair was taken by Mr. Vinson, the Secretary of the United States Treasury. A lawyer by profession, he thought in judicial and constitutional terms and his formal conception of the Fund and Bank differed fundamentally from the more flexible view taken by Keynes and many others. In spite of the care which Keynes had given to the drafting of the formal agreements at Bretton Woods he knew that the major difficulties in establishing the agencies on a sound basis were still to come. To win confidence, establish contacts, acquire prestige and international standing would be difficult and all depended upon how the agencies conducted their business and day to day affairs in the early stages. Personal antagonisms deepened the intellectual differences. Vinson had seen something of Keynes during the Loan negotiations and knew his calibre as a negotiator and disputant. He and the American delegation were determined to brook no opposition from any quarter. America's great voting power must serve to drive her wishes through the meeting.¹

A good example of such driving was the final settlement of the old question of the location of the Fund, on which Britain had reserved judgement at Bretton Woods. Keynes still hoped that it might be possible to centre the Fund in New York, the one city of the United States with any claim to cosmopolitanism, where there was a money market and where it would be possible to maintain links with the headquarters of the United Nations. When this matter was broached to Vinson, however, he declared that 'the American delegation had decided that both institutions should be placed in Washington and that this was a final decision, the merits of which they were not prepared to discuss.'² In fact the American delegation were by no means unanimous in their support of this decision but Vinson had quelled any incipient insurrection by going direct to Mr. Truman who instructed the delegation that this

¹ Another factor which may have contributed to the hardening of the American attitude towards Britain was the fact that, since Vinson had become Secretary, the star of Harry White had waned at the Treasury. This enigmatic figure who, in his last days and for years after his death, was the target for political mudslinging might, with his former influence, have thrown his weight into the scales on the side of sanity. Even the moderation and sobriety of Mr. Harrod's account cannot conceal the impetuous, power-seeking thrust of the American group at Savannah. It was a case of 'We have the machine. O.K. Boys, let's use it.'

² Memorandum by Lord Keynes on Savannah, March 27, 1946. Quoted in Harrod, *op. cit.*, p. 630.

was an 'absolute direction to the American delegation from which they were not to be free to depart in any circumstances.'¹ According to Keynes's Memorandum the decision was motivated purely by American domestic considerations: to strengthen the Federal Reserve Board's position relative to the Federal Reserve Bank of New York. Fears that the international agencies were to be politicians rather than economists grew strong in the minds of some of those who had created them.²

There was, too, the question of the Executive Directors. The plan of the United States was that there should be twelve directors, and twelve alternates, all permanent officials resident in Washington and drawing large salaries. The alternative would be to have the directors part time; the bulk of their efforts being given to work in the financial field of their own countries. In this way there might be useful cross-fertilisation of national and international effort. Here again the alternatives were British and American; a small part-time economic and financial intelligentsia; or a large resident and politically minded executive, each individual conscious of the watchful eye of his embassy round the corner. The American view triumphed. Many of the small nations were at this time applicants for American stabilisation loans and feared to oppose the American will, whatever they may have thought of it. On the question of salaries for the Executive Directors, the British voted for a reduction, but they did so alone. Even Keynes was hesitant to use his full personal power to halt the American battering-ram, for the Anglo-American Loan Agreement was not yet through Congress. It was a sad and inauspicious start for an international institution upon whose early planning such care had been lavished.

II

It is impossible in moderate compass to deal with the minutiae of Fund business since 1947. We shall, therefore, deal *seriatim* with the Fund's activities in the main fields of its operations as follows:

- (a) 'The Fund's task of assisting in the establishment of a multi-lateral system of payments in respect of current trans-

¹ *ibid.*, p. 630.

² Never surely were fears and presentiment of failure couched in such an elegant speech as in that with which Keynes followed Vinson at the opening of the Savannah Meeting. Keynes's fear that the Bretton Woods twins would grow up politicians was only too well founded.

actions between members and in the elimination of foreign exchange restrictions',¹

- (b) Exchange rate policy,
- (c) Provision of currencies,
- (d) Gold Transactions and
- (e) Other functions.

(a) The Fund's task of re-establishing multilateral trade and of ending direct restrictions and discriminatory practices has its motivating force not only in its own Articles but in Article VII of the Mutual Aid Agreement under whose stimulus the Fund and Bank were originally created. Under Article XIV, sec. 2 of the Fund Agreement members were to be permitted during the post-war transitional period 'to maintain . . . restrictions on payments and transfers for current international transactions', but were pledged to 'withdraw restrictions . . . as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balances of payments in a manner which will not unduly encumber their access to the resources of the Fund'. In accordance with its articles, three years after the beginning of exchange operations the Fund reported on the restrictions remaining in force. A second report followed in April 1951 and by March 1952 any member still retaining any restrictions on current transactions, on the convertibility of foreign-held balances, or engaging in any discriminatory currency arrangements or multiple currency practices was to consult with the Fund as to their further retention — the Fund having coercive powers upon the member to remove these. Thus the Fund model envisaged a progressive dismantling of exchange controls, restrictions and discrimination, during the transitional period culminating in complete multilateral trade by the time the quinquennium ended.

The Fund's task was then a twofold one: to re-establish a multilateral system of payments in respect of current transactions between members; and to induce member nations to discard the use of direct controls — such as import quotas and embargoes — and discriminatory devices such as multiple currency rates or discriminatory quotas and tariffs designed to influence their balance of payments with the world or with particular countries.

The means whereby multilateral trade was to be achieved were

¹ *Second Annual Report on Exchange Restrictions*, April 1951.

not defined. Such a condition would require one of two conditions: the Fund itself would have to supply unlimited and unconditional multilateral drawing rights; an international currency would have to be created, or gold or a national currency such as the pound or dollar would have to serve in lieu thereof. The first of these conditions was certainly not fulfilled for the Fund's currency resources were not great and were made available to members only on certain conditions.¹ Gold was to be used by the Fund for defining currency values and payments might be made in gold but at the discretion of members. No attempt was made to establish gold as a world currency. It was, it seems, on the establishment of the pound and dollar as convertible currencies that the Fund chose to rely and the success of its programme of restoring multilateral trade rested on the hope that at the earliest possible moment the pound should join the dollar as a freely convertible world currency. With that formidable hurdle behind, the way would be clear and the going easy. The desire for sterling to be made convertible was shared by the American government who pressed their wishes strongly upon the British government. Under the Fund Agreement convertibility of a currency was to be obligatory at least by the end of the transition period (March 1952) but the Americans seized upon the Anglo-American Loan Agreement of December 6, 1945 as an opportunity to force Britain to make an earlier attempt. Under the Agreement sterling was to be made freely convertible within one year of the first drawing upon the loan — a commitment which Britain had to accept — albeit with grave misgivings. The failure of the British convertibility experiment in July 1947 did small service to the cause for which the Americans had pushed their claim and has probably had a retarding influence upon the movement towards sterling convertibility since that time. The fact that it was made at an unsuitable time and without adequate safeguards to protect British reserves does not prevent an extreme caution on the part of government in making a second move in the same direction. During 1950 there was a quiet extension of the multilateral use of sterling through the administrative action of the Bank of England,² but the movement was short-lived and clearly any major step in the direction of sterling convertibility must wait upon a

¹ Cf. p. 199 below.

² During 1950 the use of special 'administrative' facilities for sterling transfers expanded by £30 mln to £155 mln, cf. *Annual Report of the Bank of England* for year ending February 28, 1951.

favourable British and Sterling Area balance of payments, particularly with the dollar area; a comfortably high level of Sterling Area reserves; and a favourable view in the minds of British policy makers, of the present and future state of American income and employment.

Direct balance of payments restrictions of the type now prevailing had their origin either in the world depression of 1929-33, when they were introduced as stop-gap measures to meet extraordinary balance of payments deficits; or in the Second World War, when they became an accepted instrument of economic warfare. When the war ended there were few countries which did not need to retain restrictions to meet balance of payments disequilibria, but it was widely supposed (and the Fund's Articles reflect the supposition) that these would be discarded as the world moved forward into quieter times. When the Fund began its exchange operations on March 1, 1947 only five members¹ did not take advantage of their right to apply restrictions during the transitional period.

The prevailing condition of many member countries was one of acute external imbalance with an inability to export until reconstruction had progressed and an immediate necessity to import on a large scale. In such conditions it would have been folly to have sought balance of payments equilibrium by depreciation. A very great measure of depreciation would have been required to limit imports and the fillip given to domestic inflation would, in many cases, have been great. It was preferable to control imports selectively and quantitatively by direct controls and rely on foreign credits to meet the deficit of the balance of payments.

The nature and stringency of the controls differed widely during the transitional period. In most European countries the necessity to conserve foreign exchange for essential imports resulted in the extension and elaboration of war-time restrictions. In Eastern Europe exchange restrictions supplemented direct and comprehensive state intervention through state trading and barter arrangements. In Latin America a very high demand for imports brought exchange restrictions, mainly through multiple currency rates, in spite of high export earnings.

By the end of the transition period there was no evidence that the tide of restriction was receding. The Fund, in its *Second Annual*

¹ El Salvador, Guatemala, Mexico, Panama and the United States.

Report on Exchange Restrictions argued that by the end of 1950 there had been a substantial lessening of the obstacles to relaxation; the exchange rate adjustments of 1949 had created a stable pattern of world prices; the growth of European production had allowed world trade to become more normal; the dollar problem had been alleviated; and with an enhanced demand for sterling and a growth of exchange reserves convertibility of that currency should soon be possible. Mr. Ivar Rooth, the Fund's managing director,¹ in his address to the governors in September 1951, elaborated this theme and pressed members to take the risk of returning to free and convertible currencies — a risk which the Fund would in many cases be willing to underwrite with its resources. Such encouragement did not achieve much. The return of world inflation in 1951 attendant upon the Korean crisis and the defence programme, the sharp swing of the terms of trade against the great importers, the recurrence of dollar shortage, and the desire to conserve exchange reserves for strategic reasons against the possibility of general war, deterred leading powers from embarking upon courses of action which they considered perilous in the extreme. At the 1951 Annual Meeting of the Fund much of the pressure for convertibility was directed towards the United Kingdom. The resultant clash of opinion illustrates well the fundamentally different approaches of the United States and of Britain to the Fund and its work. The American view and that which impelled the Fund was clearly that the Fund was primarily an organisation to seek and maintain multilateral trade; the British view was that the Fund existed to supply international liquidity and help to stabilise balances of payments. Britain's answer to Mr. Rooth's plea was, therefore, that the Fund should use its resources to help member countries balance their external accounts, that its intervention in the field of international management should be designed to bring about stability of international prices and thereby of exchange rates — in short that convertibility was contingent and must wait upon world conditions which it should be the duty of the Fund to foster. As for the Fund's offer of assistance for those who went forward with the work of liberating payments, it was useless for the Fund to expect borrowers on such conditions, as the external imbalance of most

¹ Mr. Rooth succeeded M. Camille Gutt as Managing Director in August 1951, and was in turn succeeded in 1956 by Per Jacobsson, formerly Economic Adviser to the BIS.

agriculture was common, while a few admitted to reliance on the proceeds of multiple currency markets as a source of revenue. Some few pleaded allegiance to group arrangements as their reason for retaining restrictions. In accordance with these views members were almost unanimous in saying that the removal of restrictions must wait upon balance of payments equilibrium.¹

The Fund seems to have expressed its views freely to members during these consultations on the means whereby they might achieve balance of payments equilibrium. The purging of domestic inflation by appropriate domestic fiscal and monetary policies and abstention from policies likely to promote inflation² were both urged upon member governments. 'Where certain countries tended to alternate between more extensive use of restrictions and more reliance on corrective monetary and fiscal measures, the Fund made clear the desirability of action of the latter type.'³

In 1953 and 1954 with improved European balances of payments, an easing of inflationary pressure, a temporary alleviation of the dollar problem, and a sense of growing confidence in economic conditions, the arguments for convertibility and an end to discriminatory controls were strengthened. The Fund undertook a series of consultations with members in the years 1953, 1954, 1955 and 1956 when, either in Washington or through the Fund staff missions, it exchanged views with some forty countries. Clearly this task of pursuing liberal payments was becoming a major part of the Fund's work. The general trend towards the removal of trade barriers in 1953 and 1954 made it also appear that, at last, some progress was being made.⁴ In this movement interest naturally centred upon the problem of sterling convertibility and with the possibility of reducing Western European discrimination against dollar goods. Once more, however, hopes of convertibility were dashed as the sterling balance of payments worsened under the influence of domestic inflation in late 1955 and early 1956. Since

¹ Cf. *Fourth Annual Report on Exchange Restrictions, 1953*, pp. 11 and 12.

² These are not specified. Presumably the Fund means excessively large investment or social security programmes.

³ *ibid.*, p. 13.

⁴ The *Fifth Annual Report on Exchange Restrictions* states that the 'exchange restrictions effectively applied were by the beginning of 1954 probably less restrictive than in any year since the end of World War II'. Cf. also *Annual Report for 1954*, p. 78. Notable changes in 1953-54 were the agreement by eight EPU countries to unify the spread between buying and selling rates for their currencies and to provide for multilateral arbitrage; and the simplification of the sterling payments system in March 1954.

the major condition of successful sterling convertibility must wait upon the achievement of real equilibrium in the British and Sterling Area balances of payments we will defer discussion of the convertibility problem until Chapter 9 when the Area and its problems will be considered. Suffice it to say here, that, in the dismantling of controls, it is not only what conditions really are that is important but also how nations interpret them and adjudge future prospects.

Two reforms in the Fund itself would enormously strengthen its arguments for liberalisation in the eyes of its members; the first, the provision of an adequate equilibrating mechanism through a flexible exchange rate system; the second, an increased holding of international liquidity (appropriate to current prices and trade volumes) freely available to members up to the amount of their quotas. In the absence of means whereby members may deal with external deficits the best that can be hoped for is a condition in which controls and restrictions are relaxed when the economic weather is fine and reimposed when it is foul or threatening. For practical purposes this is likely to mean that every time the winds of recession blow in the United States the non-dollar world dons its overcoat of controls; when the sun shines once more in the United States the non-dollar world may take the overcoat off, but, more likely, it will only turn down the collar. Such an alternation of policies is no more than the logic of the 'scarce currency clause' which allows a member to impose restrictions and to discriminate against imports from a country whose currency has been declared scarce. If, however, exchange rates were free to move, altering the terms of trade in favour of the United States this would serve as a correcting influence. If also the United States' dollar holding of the Fund were large enough for it to postpone with safety a declaration of scarcity of the currency, there would be no need for exchange controls or discrimination by the non-dollar countries unless the recession was severe and prolonged.

To some extent also the attack upon direct controls in the international economy has been weakened by the failure of the Havana Charter and ITO. In the original conception two agencies were to be responsible for the international supervision of trade; the IMF seeking the abolition of monetary controls over international payments, while the ITO dealt with import quotas and commercial policy. The two organisations would therefore have been inter-

dependent and their work would have been closely co-ordinated. Some of the work intended for ITO has been carried on by GATT which in its nine sessions has secured numerous tariff reductions and, in other cases, undertakings not to raise duties above their present level. Also some of the provisions of the Havana Charter have been incorporated in the General Agreement, notably that under which member nations agree to resort to only quantitative controls for balance of payments adjustment. The Agreement is, however, hampered in its scope in that it has no power to make member nations dismantle controls or amend duties which are legislatively sanctioned in their own countries.¹ Many of the existing quota systems are legislatively sanctioned and are therefore inviolate so far as GATT is concerned. Moreover, although at first sight GATT's progress has been considerable, it must be remembered that many of the decisions agreed upon have been stand-still agreements in respect of existing duties; that although in early discussions members appeared ready enough to waive tariffs, these were often upon rare goods or upon goods which, even in the absence of a duty, would rarely enter into trade. As discussion has moved towards those duties on goods which are important to member nations progress has been halted, either because these are the subject of legislative enactments or because the opposition has been stiff. There is, it appears, a hard core of tariffs and restrictions which GATT either cannot touch or upon which the attitude of members is implacable and unrelenting.

Professor Brian Tew² suggests four factors which have contributed to the lack of progress in removing restrictions on payments. Firstly, payments restrictions have often been imposed or retained in defiance of the Fund, and for reasons other than that of balance of payments disequilibrium. Secondly, the Fund has not tried to arrange reciprocal concessions in payments restrictions. Thus countries who have imposed restrictions to protect their external accounts have feared to remove these as long as similar measures were being enforced by their competitors. Thirdly, the division of labour which exists between the Fund and GATT has meant that

¹ Had the Havana Charter been ratified by the signatory powers this proviso would not have been necessary. By accepting the principles of ITO the member legislatures would have given their sanction to changes in duties and/or practices even provided for by their own legislation.

² Cf. *International Monetary Co-operation 1945-56*, London (Third Edition), 1956.

it has been difficult to negotiate concessions in the field of payments in return for concessions in restrictions operating on trade. And lastly, there has been little appreciation in the postwar world of the advantages to be reaped from a return to multilateral trade and many countries, seeming to prefer the use of controls, give only lip service to the movement for their abolition.

It seems almost that controls are self-perpetuating, for as long as imports are directly restricted and countries exclude goods for balance of payments reasons the international price system cannot be made to work. In order that an adverse balance of payments may be corrected by depreciation of the deficit country's currency unit the elasticity of demand for its exports must be high. It can only be so in the absence of controls where demand can respond fully to price variation. Thus controls exist because there seems no other way of dealing with imbalance, and the only method which there might be is precluded by the existence of the controls. If the international economy is to find its way back to multilateral trade and free currencies means must be found to break out of this vicious spiral.

(b) We turn now to the Fund's exchange rate policy. In a practical sense, this has two aspects both of which were catered for in the Articles: the fixing of initial parities, and the alteration of parities from time to time in order to preserve international equilibrium. Article XX, sec. 4 provided for the submission to the Fund by members of the initial par values of their currencies, and for the establishment by the Fund of a system of par values: Article IV, secs. 5, 6, 7 and 8 defined the machinery through which members might make changes in the par values of their currencies.¹

The establishment of a structure of initial exchange parities to govern the foreign transactions of the postwar world was a formidable task for the Fund to embark upon at the very threshold of its career.² This was the first time that a number of nations had sub-

¹ Briefly sec. 5 precludes the changing of a par value save to correct a 'fundamental disequilibrium', allows for a 'once-for-all' alteration of not more than 10 per cent on the initiative of the members; and defines the Fund's coercive powers over members. Sec. 6 deals with the effect of unauthorised changes; sec. 7 with uniform changes in par values; and sec. 8 with the maintenance of the gold values of the Fund's assets.

² For a discussion of the problems involved in the settling of exchange rates and of the Fund's approach, see Lloyd A. Metzler, 'Exchange Rates and the IMF', *Postwar Economic Studies* No. 7, September 1947, Federal Reserve Board.

mitted their exchange rates to be considered, and possibly amended, by an international organisation. On September 12, 1946, the Executive Directors of the Fund requested each member 'to communicate within thirty days the par value of its currency based on the rates of exchange prevailing on October 28, 1945 — the sixtieth day before the entry into force of the Agreement'.¹

M. Camille Gutt, the then Chairman of the IMF, tells us² that a very detailed investigation was made of the existing and prospective position of every member, and that in each case-study both immediate and ultimate problems were closely considered. Much data was collected and 'innumerable discussions were held'. The 'ultimate problem' was to know what would be the international economic position of a country at the end of the transition period and what exchange rate would then be appropriate to its currency. From the global point of view it was assumed that the country would have completed reconstruction, that income and employment in the United States would be stable and at a high level, that Great Britain would have restored equilibrium to her balance of payments at a level of imports at least equal to the 1936-38 level, and that all of the world's major currencies would have been made convertible. Given these circumstances the aim was to know something of the real terms of trade which for each country would give equilibrium to its external accounts. The 'immediate' problem was simply to know what influence the prevailing exchange rate would have upon the external position of an economy within the next year or two, what influence it would have upon reconstruction, and whether it would enable the country to attain tolerable balance by the end of the transition period. On December 18, 1946 the Fund announced the certification of the par values of 32 of its 39 members — the other seven postponing submission of their parities until a later date. Some of these — Austria, Turkey, Ceylon, for example — subsequently established par values. In June 1956 nine members had not yet established a parity — China, Greece, Italy, Uruguay of the original seven, and Thailand, Indonesia, Afghanistan, Israel and Korea, who joined the Fund later. The official parities of Peru, France and Canada have lapsed and no new parities have been agreed. The initial par values were, in all cases, those which

¹ Cable to member governments quoted in *First Annual Report of the IMF*, p. 16.

² Cf. *The Practical Problem of Exchange Rates*, Camille Gutt, Lecture at Harvard University, February 13, 1948.

had been proposed by the members and were based on existing rates of exchange.

The wisdom of this action has been questioned.¹ If it is true that the establishment of unsuitable exchange rates following the First World War was a contributory cause of the monetary chaos of the 'twenties,² then it follows that one of the most important tasks of the Fund was its initial one of establishing a world system of exchange rates. Yet no attempt was made by the Fund to establish equilibrium rates. About half of the parities accepted were the same or higher than in September 1939 which was surprising inasmuch as prices in many member countries had increased from 300 to 1000 per cent during the war period.³ Lloyd Metzler, who has calculated the purchasing power parity exchange rates (for both wholesale and retail prices as compared with the base period October 1936–June 1937) of a number of Fund countries in November and December 1946, has compared these with the Fund accepted rates and found that out of 19 countries, 9 had official rates well above the parity rates (either for wholesale or retail prices) while only in three cases, Canada, South Africa and the United Kingdom — was the official Fund rate lower than the parity rate. It cannot be claimed that such a comparison is more than a rough yardstick, but the fact that the parity rates tend to fall short of the rates announced by the Fund is a general indication

¹ Cf. R. F. Mikesell, 'The Rôle of International Monetary Agreements in a World of Planned Economies', *Journal of Political Economy*, December 1947.

² Cf. J. Tinbergen, *International Economic Co-operation*, pp. 161–2.

³ Samuelson argues that the acceptance of the 1946 parities resulted in a condition in which the exchange rates for non-dollar countries were over-valued and that for the United States was undervalued — the result of prices having risen much more in Europe than in the United States. Cf. 'Disparity in Postwar Exchange Rates', chap. 22 of *Foreign Economic Policy for the United States*.

Lloyd Metzler has made an interesting comparison of the initial exchange rates announced by the Fund with the rates existing before the war. Selecting as a prewar base the period October 1936 to June 1937 he found that, with the exceptions of Canada, Cuba, Columbia, Costa Rica and Venezuela, the postwar rates were lower. Variations varied from 71 per cent for the French franc to 5 per cent in the case of the Danish krone. In the case of countries which had been occupied by Germany there was a complete break with the past and, as costs and prices had risen relative to the United Kingdom and the United States, most of such countries settled upon more or less arbitrary but considerably devalued rates in 1945 and proceeded to maintain these by exchange control. In the case of the United Kingdom the rate of \$4.03 = £1 was that which had obtained at the beginning of British Exchange Control in September 1939 and which was to continue until September 1949. In general it may be said that the period from 1938 to 1940 was one of depreciation but that the pattern of exchange rates in 1946 was very similar, for sterling and Latin American countries, to that which had obtained in 1939. Cf. Lloyd Metzler, 'Exchange Rates and the IMF', *Post-war Economic Studies No. 7*, Federal Reserve Board.

that the postwar exchange rates of a number of countries were higher than those likely to be consistent with long period equilibrium.

The Fund realised that the initial parities were unsatisfactory and defended its unquestioned acceptance of the submitted parities both at the time¹ and subsequently.² The main points in its defence were: that, in the immediate postwar world, trade would flow in obedience to the needs of rehabilitation and reconstruction, and export volumes would be determined by ability to produce rather than by price; that as soon as an existing parity was shown to be an obstacle to international trade it could be changed with the approval of the Fund; that, during the transition period, parities should be adjusted as required and that the exchange rate policy of the Fund should be such as to produce balance of payments equilibrium for the main economies by the end of the transition period. An ultimate structure of equilibrium rates would only be attainable after the transition period had expired, and should, until then, be the subject of detailed research by the Fund. It might also have been argued that along any line of action there were difficulties and the choice of what to do was necessarily determined by the balance of advantage. The Fund could attempt to construct a world system of equilibrium rates at once — a task which in view of world conditions, the newness of the Fund's establishment and the technical problems involved would have been immensely difficult;³ or it

¹ Cf. 'Statement Concerning Initial Par Values', Appendix X of *Annual Report of IMF* for year ending June 30, 1947. The following extract summarises the Fund's position:

'The Fund realises that at the present exchange rates there are substantial disparities in price and wage levels among a number of countries. In present circumstances however such disparities do not have the same significance as in normal times. For practically all countries exports are being limited mainly by difficulties of production or transport and the wide gaps which exist in some countries between the costs of needed imports and the proceeds of exports would not be appreciably narrowed by changes in their currency parities. In addition many countries have just begun to recover from the disruption of war and efforts to restore the productivity of their economies may be expected gradually to bring their cost structure into line with those of other countries. Furthermore for many countries now concerned with combating inflation there is a danger that a change in the exchange rate would aggravate the internal tendencies towards inflation.' Cf. p. 71.

² Cf. 'Exchange Rates and the IMF' a lecture by Camille Gutt given at Harvard and printed in *Foreign Economic Policy for the United States*, Ch. 11.

³ If the Fund had determined upon a bold policy of settling initial parities two courses of action were possible: it could have tried to estimate new parities by a rough purchasing power parity method, or it could have requested members temporarily to set their rates free and allow them to find their own parity. It is

could proceed with piecemeal changes in parities to suit changes in world conditions as they appeared. On the whole, it must surely be admitted that the latter was the safer course.

It was also the more popular course. The fact that most of its members wished the existing rates to be accepted must have weighed heavily with the Fund. It was generally realised that if the Fund insisted on a revision of rates this would be in a downward direction. Almost all countries, however, wished to maintain their rates at as high a level as possible in order to reap the disinflationary benefit of cheap imports. In the inflationary conditions which prevailed, and seemed likely to continue, artificially high rates were felt to have little or no retarding force on exports — not at least as long as sales were governed by the problem of procurement. Many countries believed in 1946 that they were maintaining a precarious balance on the knife-edge of full employment and that a rise in their import bill would have plunged them into a spiral of cost inflation. Looking back it must be admitted that there was cause for such fear and the Fund would have taken a grave risk if it had insisted on wholesale devaluations.

The Fund's view of exchange rates was practical rather than doctrinaire. An exchange rate, it argued, has two functions: to enable a country to export its surplus products, and to limit its imports to its capacity to pay for them. In the conditions of the immediate postwar world it was for most countries impossible to conceive any practicable exchange rate which would perform this function. To countries devastated by war or, at best, starved of capital and consumer goods the demand for imports was insatiable and to have attempted to limit them through greatly depreciated exchange rates would have been to imperil the internal stability of these countries and to force the international economy into a strait jacket. In the meantime such selective import limitation as there must be had best be done by direct controls. The one practical test which the Fund applied to a submitted parity was: does it enable the country to export? In view of the Fund's approval of the submitted parities we must assume that this test was satisfied. M. Gutt claims that the Fund's policy was justified by the fact that in the year 1947 every country in Western Europe increased its exports

doubtful if the first method would have amounted to more than a series of guesses; while the latter might have presented some debtor countries with impossible terms of trade through the depreciation of their rates.

more rapidly than its production. Moreover, the policy was, he claims, supported by 'the best informed central bank opinion in London, Ottawa, and New York'.

But there are two important questions which should have been asked as to the Fund's action in respect of initial parities: firstly, would not the trade structure of the post-transition period be developed by the rates existing during the transition period so that vested interests for the retention of such rates would develop, and secondly, in adopting a passive attitude towards exchange rates at the outset would not the Fund weaken its authority to propose subsequent changes in rates? Now, looking back upon the events of the last ten years, there is little doubt that an affirmative answer would have to be given to both these questions. Although for a time, price may not have determined export volumes, the new structure of trade was in part built up by relative prices which became increasingly important as basic deficiencies were met and a growing element of choice returned. Moreover, many countries who might have balanced their external trade freely at a lower rate of exchange preferred, for reasons already explained, to maintain rates which probably over-valued their currencies, relying on the use of direct controls to deal with their balances of payments. It is likely that the failure of the international economy to abandon direct exchange controls has been in great part due to the alluring advantages under such world conditions as have existed, of maintaining high rates. By the end of the transition period the Fund's power to initiate a new structure of exchange rates had waned. The feeling that the power to order its exchange rate is something which a nation should never delegate to external authority had certainly grown stronger, and by its policy, however rationally based, the Fund had allowed the initiative in exchange rate policy to pass out of its hands. Certainly it is hard now to imagine a positive plan involving changes in parities being implemented by the Fund with the consent of its members. Nor in the matter of periodic rate adjustments did the Fund seem to be impelled by any clear ideas as to the role which it wished exchange rates to play. There seems to be substance in the criticism of one writer who asserted that while the arrangements for dealing with exchange rates after World War II seemed excellent by comparison with the currency anarchy which followed World War I the ultimate result was not very different.

The sterling devaluation of September 1949 and the complete

realignment of parities which resulted from it were carried out with the passive approval of the Fund but certainly without its aid.¹ If the Fund had lived up to its early exchange rate policy declarations it would have called for a review of parities in 1948 when it was evident that relative prices were beginning to influence the export sales of certain countries, but it did not do this. The *Annual Report* for 1948 noted the restraints that exchange rates were beginning to exercise but went no further. If during late 1948 and early 1949 the Fund had pursued a positive policy and suggested to members a planned revision of parities it would probably have been supported by its leading members and might well have enhanced its prestige and changed its subsequent history. But it remained aloof. In default of a policy it seems to have fallen back upon a series of maxims for good exchange rate behaviour by members. Of these the two most important were undoubtedly its belief that it must interpret its articles with punctilious exactness and an abhorrence of fluctuating rates. When the French government devalued the franc in January 1948 and established a multiple rate for the currency, the Fund promptly denied France the right to draw upon its resources. It is difficult to decide whether the Fund's censure was entirely on economic grounds or on grounds of France's unconstitutional behaviour. Its toleration of multiple currency rates for an emergency period by Italy and Ecuador seems to indicate that if France had proceeded with decorum all might have been well. Similarly when the Canadian dollar was freed on September 30, 1950 the Fund's communiqué gave grudging and frigid approval. It is fairly certain that any proposal to free a major currency such as sterling would invoke serious dispute as 'fluctuating

¹ This is surprising in view of the fact that such a widespread adjustment of exchange rates was foreseen by the Fund and should have been prepared for. In the first *Annual Report* of the Board of Directors in September 1946 the need for a readjustment later in the transition period was admitted: 'We recognise that in some cases the initial par values that are established may later be found incompatible with the maintenance of a balanced international payments position at a high level of domestic economic activity. . . . Countries may maintain foreign exchange values for their currencies which are not for the time being a great handicap to the sale of their exports, but which prove to be too high when production is revived all over the world and the immediate shortage of import goods is in large part met. Such countries may later find difficulty in selling sufficient exports to pay for needed imports. When this occurs, the Fund will be faced with new problems of adjustment and will have to recognise the unusual circumstances under which the initial par values were determined. It is just at such times that the Fund can be most useful in seeing that necessary exchange adjustments are made in an orderly manner and competitive exchange depreciation avoided.'

rates are not in accord with the long-term objectives of the Fund'.¹

It has been argued that the existing method of adjusting exchange rates only at long intervals and to meet a fundamental disequilibrium is unsatisfactory in that it leaves the international economy without any automatic mechanism of adjustment and that a system of fluctuating rates, under the influence of stabilisation funds, would be superior to the present adjustable peg method.² If that argument be accepted there remains the task of reconciling the Fund to such a change of policy. It is necessary, therefore, to examine any grounds the Fund may have for its aversion to freely fluctuating rates.

The free-rate argument was gaining acceptance as early as 1947 and in its *Annual Report* for 1948 the Fund made a half-hearted attempt to reply to its critics. No attempt was made to examine the merits of a true free-rate system, but the Report drew attention to the defects of so-called 'free' systems obtaining in China, Greece, and Italy at that time. Such free-rate systems were, it was argued, only justifiable in the cases of countries whose price levels were still rising rapidly and no fixed rate could long reflect underlying realities. As soon, however, as prices stabilised, efforts should be made to achieve stable exchange rates for these countries. The existing 'irregularities' were only tolerable as interim measures. Whether intentionally or otherwise the Fund in this way avoided the real issue of whether the system of fixed par values subject to occasional adjustment was working effectively as a medium of international adjustment.

The devaluations of 1949 were followed by a short period of relative stability which gave way to renewed inflation under the influence of mounting defence expenditure, the outbreak of the Korean War and the rise in primary commodity prices. There was a sharp deterioration in the terms of trade of the United Kingdom during 1951 and there, and in other countries, there was a strong belief that the devaluations had gone too far and that a further revision of exchange rates, this time in an upward direction, was called for.³ This was accompanied by 'some advocacy not only of

¹ A phrase used by the Fund in its negotiations with Italy on the subject of free rates for the lira. Cf. *IMF Press Release* of December 4, 1947.

² Cf. pp. 86-100.

³ Some critics argued that the devaluations had been unnecessary and that even in 1949 the pound had not been over-valued.

fluctuating exchange rates to suit particular circumstances facing a given country but even of a large number of rates fluctuating at the same time'. Those who favoured a fluctuating-rate system also argued 'that each rate of exchange should move so as to protect the domestic economy from pressures arising abroad, and, under other circumstances, that the exchange rate should protect the balance of payments against pressures arising out of domestic economic policies.'¹ In its *Annual Report* for 1951² the Fund replied to these critics and gave its objections to a fluctuating-rate system — the main points of its defence being as follows. Firstly, 'short-run changes in the exchange rate are either no test or a very poor test of basic economic inter-relationships.' This seems to mean that, for given economic and financial conditions and for given domestic policy of a country, there is an appropriate exchange rate. Whether an exchange rate is the correct one for the given conditions can only be determined after there has been time to observe the reactions of the balance of payments to that rate over a period. Short-term reactions to changed price-cost relationships are unreliable and a rate which is constantly changing gives no opportunity to find what is the true equilibrium rate.³ Secondly, 'past experiences with fluctuating rates of exchange have proved that movements in the rate are significantly affected by large speculative transfers of capital' and adjustments in rates of exchange should be made in a manner which minimises distortions through speculation. While this may in part be true it is doubtful whether speculative influence could be so damaging under a free-rate system as they have proved under the adjustable peg system which, as has been already pointed out,⁴ provides a one-way option for speculators and even allows persistent speculation to imperil the stability of a currency. Clearly the Fund sees the international adjustment process not as a continuously moving set of variables whose relationship may be held in equilibrium by the movements of one key variable, but as a series of more or less static situations to each of which a particular exchange rate is appropriate. As one situation gives way to another so the necessary changes in rates may be made and for these the

¹ Cf. *Annual Report for 1951*, p. 37

² Cf. pp. 36–41.

³ The Fund's argument could be summed up by saying that only in the long period are import and export demand elasticities high enough to give a depreciation any chance of being successful. Short period movements of the rate are then ineffective while occasional once-over changes are not.

⁴ Cf. p. 98 above.

Fund's Articles provide adequate consultative machinery. The Report omits to mention, however, that such a conception of international monetary management demands a large and appropriately distributed stock of international liquidity so that the transitions from equilibrium to equilibrium can be made without destabilising effects upon individual countries — certainly a larger stock than is at present available. The only argument for free rates which the Fund will tolerate is that 'there may be occasional and exceptional cases where a country concludes that it cannot maintain *any* par value for a limited period of time, or where it is extremely reluctant to take the risks of a decision respecting a par value.' Even for such a country the Fund has many conditions, and it clearly regards it as intolerable (a) that any of the major currencies should ever fall into this category or (b) that any considerable number of exchange rates should be allowed to fluctuate simultaneously. A member of the Fund cannot, under the Articles, abandon a par value that has been approved by the Fund except by concurrently proposing to the Fund the establishment of a new par value. A country may, however, inform the Fund that it finds itself unable to maintain its rate of exchange within the prescribed margins and that it is unable to carry out its obligations under sections 3 and 4 (b) of Article IV, and, 'if the Fund finds the arguments of the member are persuasive it may say so, although it cannot give its approval to the action.' It would be assumed that the condition would be temporary and the Fund would hold a watching brief to see that justification for the action was sustained. The Fund concludes its defence of the adjustable-peg system in terms which brook no further argument. 'The par value system is based on lessons learned from experience. There is ample evidence that it continues to be supported by the members of the Fund. Exceptions to it can be justified only under special circumstances and for temporary periods.'¹

The attitude of the IMF towards fluctuating rates as an adjustment medium is reflective of an intellectual time-lag. In 1944 when the Fund was established free rates were, for many reasons, sadly out of fashion. No attempt was made to allow for them under the Fund mechanism and the attitude of the Fund was hostile from the outset. Now, after more than a decade, economists and even bankers are having second thoughts on this matter and the neces-

¹ *ibid.*, p. 41.

sity for some variable through which international adjustment may be made is being realised.

The only case since the war of a major economy adopting a free rate for its currency¹ is that of Canada, who abandoned official support of the fixed par value in September 1950.² This step was taken in the hope of checking a speculative inflow of capital (generated by favourable reports on Canada's economic position and a belief that the Canadian dollar was undervalued relative to its United States counterpart) which was increasing the domestic monetary supply, lowering interest rates and contributing to inflation. During 1950 the inflow had amounted to about C\$700 mln. In 1951, under the influence of the free rate there was a great reduction in the capital inflow and in the following year capital was exported to the value of approximately C\$630 mln. During 1951 the range of fluctuation of the currency was only 4 per cent, in 1952 less than 5 per cent, and in the first half of 1953 less than 3 per cent.³ The most interesting features of this experiment were the way in which the desired objective was attained, the narrow range of fluctuation of the currency despite the sensitivity of the rate to trade balance changes, and the fact that capital movements have played an equilibrating rather than a disturbing role. The success of the Canadian experiment should induce the Fund to examine constructively proposals for further experiments in free rate adjustment. Moreover, the Canadian case is a useful demonstration of a difficulty inherent in the Fund mechanism — that of deciding upon a new fixed rate. The Canadian Government was convinced that appreciation of their currency was, in the circumstances, the appropriate step for them but they were uneasy as to the measure of appreciation or of how long the economy would be able to sustain a higher rate. Rather than make an estimate of the new rate which could be little better than a guess they preferred to free the rate and let it find its own level, — a decision of which it is hard to doubt the wisdom.⁴

¹ That is apart from the 'free' markets associated in certain countries with multiple currency practices. Some of these will be discussed below.

² The Fund is said to have had only 24 hours notice of the Canadian Government's intention.

³ Cf. *Annual Report of IMF for 1953*, p. 68.

⁴ One writer has suggested that this difficulty should be met by the Fund allowing the freeing of exchanges for specified periods during transition from one parity to another. Cf. A. A. F. Muhammad, 'Some Aspects of the Exchange Rate Policy of the IMF', *Pakistan Economic Journal*, Lahore, September 1951.

Another aspect of the Fund's exchange policy has been its efforts to get rid of disorderly cross rates between currencies.¹ Under free exchange markets the values of currencies in terms of each other are the same throughout the world and temporary divergences are ironed out by arbitrage as they appear, but under inconvertible currencies where trade must be balanced bilaterally and where parities are held often at very arbitrary levels by official intervention or by the special circumstances of the bilateral market, cross rates may have little relationship to the official Fund parities or to the true trading position. Disparate cross rates have, since the war, existed in several countries on a legal basis and in many on an illegal or tolerated basis. The Fund has energetically sought to abolish them, asserting that they distort the pattern of trade, impair the ability of some countries to earn dollars, and diminish the inducement which other countries have to earn dollars. They are particularly serious when they operate against one of the great currencies in which international trade is carried on.

One case may serve as an example to illustrate the effects of a disorderly cross rate. When in January 1948 France devalued the franc by 44.4 per cent relative to the dollar she established also a free market for gold and dollars. Half the proceeds of exports to the United States were to be sold in the free market and half to the authorities at the official rate of 214.7 frs = \$1. Essential imports were to be at the official rate and non-essential imports and certain invisible transactions at the free rate, which established itself at a level of 360.7 frs = \$1. Thus while the official devaluation of the franc was 44.4 per cent, the free market represented a devaluation against the dollar of 61 per cent. A distortion of the pound-dollar cross rate followed the French action. Prior to the devaluation the official rate was £1 = \$4.03 which was equivalent to a cross rate of £1 = 480 frs. At the devalued official rate the pound-franc rate became £1 = 864 frs. The average franc-dollar rate for free and official markets was 261 frs = \$1, which, when converted into pounds, meant a cross rate of £1 = \$3.31. This meant that British goods exported to France and thence to the United States were at a depreciated rate, and there was a tendency for trade to be pulled in this direction. A tie costing £1 in the United Kingdom and quoted at \$4.03 by British exporters could be bought by the French

¹ A 'cross-rate' may be defined as the exchange relationship between two currencies resulting from their relationship with a third currency.

for 864 frs (official rate) and offered to an American importer at \$3.75, which would give the Frenchman 978 frs (at the average rate of 261 frs = \$1), i.e., ignoring transport costs. This would mean a profit of 114 frs per tie to the Frenchman and an advantage of \$28 to the American.¹ Alternatively merchants of any nationality might buy British goods in France for export to the United States. The adverse effect upon the international economy of a disorderly cross-rate is then two-fold: trade is diverted into a circuitous course at higher real cost than if it followed the direct channel, a course which probably has little to do with the fundamental influences which determine a stable pattern of world trade; while the exporting country earns with part of her exports an inconvertible soft currency which she may not require, in place of a universally convertible currency of which she stands in need.

Two major examples of disorderly cross-rates have occurred. The first was the case of Italy, who joined the Fund in March 1947. No par value was agreed for the lira and, under the currency system then prevailing in Italy, all Italians who received foreign exchange were required to sell one half of such receipts to the monetary authority in Italy at an official rate of 350 lire = \$1, while the other half might be sold on a free market through authorised banks. The result was that sellers of foreign exchange received a price which was the average of the official and free rates. On November 27, 1947 the system was modified so that half of all foreign exchange receipts sold to the monetary authorities were at a rate established each month as the average of the free market rates of the previous month with upper and lower limits of 650 lire = \$1 to 350 lire = \$1. Although the Fund disliked this arrangement, and said so, it had no choice but to allow it to continue. The economic conditions in Italy were exceptional and the arrangements were regarded as only temporary. From Britain's point of view these arrangements were particularly obnoxious since they gave rise to conditions similar to those described in the French example and affected the dollar-earning capacity of the Sterling Area at a time (March 1947–November 1948) when its balance of payments difficulties were acute.² The unfavourable cross-rate was, however, eliminated in

¹ Export and import restrictions may limit such practices but they can hardly check them entirely if the goods involved are raw materials or half-finished goods which can be made up into finished products and exported to the United States.

² This was the critical period between the exhaustion of the American loan in the autumn of 1947 and beginning of Marshall Aid in 1948.

November 1948 when agreement was reached between Italy and Britain which ensured that sterling-lire quotations would in future be pegged to the dollar quotations at the cross-rate of \$4.03 = £1. No official par value for the lira has yet (1956) been approved by the Fund.

The other notable case was that of the French devaluation already described. Although the Fund was not averse to a devaluation of the franc, which it regarded as necessary, it took exception to the multiple currency arrangements on the grounds that they might allow the French to depreciate the franc competitively relative to other currencies and that the discount to which certain other currencies would go in the free market might raise doubts as to their strength and make it difficult for them to maintain their par values. The Fund refused to approve the plan which the French government submitted to it and denied France access to its resources when the plan was implemented.¹ The French market resulted in a 'disorderly' sterling-dollar cross-rate in Paris which continued until October 1948 when the sterling-franc and sterling-dollar rates applicable to trade transactions were co-ordinated by reference to the franc-dollar rate for trade transactions. Thus the disorderly cross-rate was left to apply only to non-trade transactions. In September 1949 after the devaluation of sterling the arrangements were extended to include trade and non-trade items.

From its inception the Fund has waged ceaseless war upon the practice by some countries of having multiple exchange rates. On this matter the South American republics have been the worst offenders, but cases have occurred among the European currencies, notably those of France and Italy described above. The practice of allowing several rates, both buying and selling, for the same currency, to prevail according to the purpose for which it is to be used or the country to whom payments are to be made,² involves three elements which are objectionable to the Fund: the element of discrimination either against specific goods or groups of goods and against particular countries; the existence of such disorderly cross-rates as have already been described; and, the element of dualism, of the existence of systems of exchange which, if effective, nullify the power and meaning of official Fund parities. It would appear that, if there must be

¹ On October 15, 1954, the Executive Board restored France's eligibility to use the Fund's resources.

² For a discussion of multiple exchange rates see p. 102 above.

discrimination the Fund would prefer it to be administered via quantitative restrictions rather than through exchange rates. 'The wide extension of differential rates to nearly all categories of payments is indeed much the same as a partial *de facto* depreciation or appreciation, and may in the course of time leave the official par value with merely a nominal status.'¹ Multiple exchange rates have great attractions for countries which do not wish to set up expensive and elaborate bureaucratic exchange control systems or where little reliance can be placed on direct taxation to procure for the state the windfall profits which accrue to importers if, with a uniform exchange rate, quantitative discrimination is practised.² 'The interest of the government in maintaining the revenue which flows from multiple currency practices strengthens the resistance to proposals for their termination.'³ Realising this, the Fund has not been doctrinaire in this matter but has treated individual cases on their merits and has taken account of differences in the background and conditions of member countries. In June 1947, for example, the Fund agreed to the use for a short period by the government of Ecuador of a multiple currency device working through the imposition of a surcharge on non-essential imports, the surcharge to be used for the retirement of government debt. This was done on the grounds that the device would serve the dual purpose of limiting the country's import demands and of checking domestic inflation by lowering the amount of domestic currency and credit.

Multiple currency practices were prevalent enough for the Fund to formulate certain principles whereby it could deal with the problem.⁴ These were circulated to members, and provided (a) for consultation as to the nature of such practices between the Fund and the member concerned; (b) since multiple currency practices are both systems of exchange rates and restrictions on payments for current transactions that priority in removal 'should be given to those features which affect exchange stability and orderly exchange arrangements among members'⁵ and (c) that multiple currency practices which are not necessary for balance of payments reasons should be removed. Members were to be obliged to con-

¹ *Annual Report of IMF for 1949*, p. 23.

² Cf. p. 104 above.

³ *ibid.*, p. 24.

⁴ Cf. Communication sent by the Fund to Members on Multiple Currency Practices, December 19, 1947. Appendix II to *Annual Report of IMF for 1948*.

⁵ *ibid.*, p. 67.

sult with the Fund as to the best means of establishing conditions which would allow the practices to be ended, and (d) the jurisdiction of the Fund over member countries and the powers which it had through its Articles were redefined and interpreted. During the years which followed, the Fund consulted with several members on their multiple currency arrangements and approved certain modifications, but there has been little change in the extent to which members have resorted to such arrangements.¹

What lessons may be drawn from the Fund's exchange policy? Predominantly there is need for reconsideration of the whole basis of that policy — the adjustable peg system. That system has worked indifferently. Moreover, it has not, as had been hoped, led to a system of stable and unitary exchange rates but to an unwieldy structure of official and non-official rates and multiple rate systems, shored up by buttresses of direct controls. We must ask whether it would not be better to demolish this structure and replace it by a system of unitary flexible rates.

First, it is necessary to examine the present case for free rates more closely. The theoretical criteria of choice as between rates of exchange which react freely to market influences and those which are adjusted at intervals to meet changing conditions have already been discussed in Chapter 4, but it may be useful to restate these and relate them to present conditions and to the record of the Fund. Upholders of the par value system claim three working advantages: firstly 'international trade will flow more speedily and easily when there is confidence in the continuance of existing exchange rates than when the future level of rates is in doubt'; secondly, a fixed rate system is more appropriate to a world of regional payments groups where a free rate for a key currency may prove embarrassing to other countries operating within the group; and thirdly, the extensive overseas investment and development plans hatched since the war might be impeded by instability in rates of exchange. These are serious arguments but the swing of opinion away from support of the present system shows that they no longer carry the weight they did. The first argument is not strengthened by the history of the postwar years. Even when exchange rates vary from day to day the trend of a currency's value

¹ Cf. Statements issued by the Fund after consultations with Columbia and Peru. Appendices III and V of *Annual Report of IMF for 1949*. Cf. also *Annual Report of IMF for 1956*, pp. 85-89.

in the market can usually be assessed. In equilibrium an existing rate being a function of supply and demand is not likely to alter greatly in such a period as the average transaction takes to complete, while in disequilibrium the trend of the market may be judged. In either case forward exchange markets afford protection. But, under the peg system, the pointers are uncertain. Traders may be held in suspense for months waiting for a revaluation which may or may not take place. Even if the date of revaluation can be guessed the magnitude cannot. It would be difficult to imagine a more unstabilising effect upon trade than that generated by the anticipation of sterling devaluation in 1949. While it is not possible to estimate the extent to which international trade is discouraged by a flexible rate system, it is hard to believe that such loss would be greater than that caused by the existing practice of adjusting a currency rate long after it has become obvious to all that such an adjustment is pending. Experience and a sober weighing of the alternatives has done much to rob the 'trade interference' argument of its force.

The second argument also has lost force. If the Sterling Area may be taken as typical of a regional payments system it should not be forgotten that the framework of that system was cast in the 'thirties when rates for sterling were free to fluctuate under market influences. The forces linking the countries of the system are now at least as strong and probably stronger than was then the case, and there seems no reason to suppose that they would be impaired by a decision to free the sterling rate, freely taken after consultation. The position of EPU is somewhat different, and it is doubtful if a flexible-rate system could be reconciled with the working of the Union in its present form. Since, however, any decision to free the rates of major currencies is likely to be deferred until these currencies become fully convertible into dollars, by which time EPU's life-span will be complete, this difficulty is not likely to arise.

Much is made by opponents of flexible rates of their supposed adverse influence upon long-term overseas investment. Yet it is hard to see that decisions whether to make or to accept loans of long date, such as those floated for development purposes, can be more adversely affected by flexible rates than by the adjustable peg system and in either event neither lender nor borrower can surely expect that the exchange rate in which they are interested will re-

main stable for decades. If flexible rates can do more to prevent recurrent balance of payments crises the effect on international lending is likely to be beneficial rather than otherwise.

Thus the stock arguments formerly levelled against a flexible-rate system have lost much of whatever force they may ever have possessed. That is not sufficient grounds, however, for adopting such a system and rejecting its alternative. We must first ask whether there has been any positive strengthening of the case against the adjustable peg system as a result of the Fund's experience.

At least three disabilities of that system have declared themselves. The first and most incontrovertible is that the peg system encourages currency speculation which, in spite of the thin-meshed net of exchange control, can imperil the stability of a currency and make it impossible for a rate, once it falls under suspicion of impending devaluation, to be held. There is no doubt that speculation against sterling played a role in bringing about that currency's devaluation in September 1949. France, Australia and Canada have all suffered in the same way. Apart from its effects the fact that this form of speculation is a one-way option which can be indulged in without fear of loss and serves no purpose is a further reason for ending it.¹ The second argument against the peg system is that too often the rate does not reflect the existing and true cost/price relationship between two currencies, but that which formerly existed. When countries pursue different domestic economic policies cost/price relationships alter frequently and even if changes in the exchange rate were made frequently it is

¹ The case for and against flexible exchange rates was argued in two successive issues of the *Westminster Bank Review* by the writer and by Sir Donald MacDougall respectively. The latter claimed in answer to the above point that a 'flexible rate would not appreciably reduce speculation against a currency under pressure' since the direction of movement of the rate may be anticipated with fair success. Even if the rate falls to the lower limit of a range Sir Donald claims, 'the chances of a reduction in the lower limit by a government that had admitted the need for flexibility would be at least as great as . . . the chances of reduction in a fixed rate'. There is weight in Sir Donald's point but the writer remains unconvinced. If the range is wide the government will be determined to hold the lower limit. Moreover, if they are wise, they will be taking measures to hold the rate, both by stabilisation fund action and by measures to reduce domestic income, long before the rate reaches its lower limit. The possibility also exists, although Sir Donald is sceptical, that, as the rate approaches its lower limit, capital will be attracted to the deficit country in anticipation of a subsequent rise. Cf. W. M. Scammell, 'What Sort of Exchange Rates?' and Sir Donald MacDougall, 'Flexible Exchange Rates', in the May and August 1954 issues of the *Westminster Bank Review*.

likely that they would reflect yesterday's conditions rather than those of today. The Fund has clearly shown that it will only approve a rate change in circumstances amounting almost to crisis. Where the necessity has to be proven in this laborious fashion, the situation may be beyond help by the time the change is made. And lastly, has it not proved disadvantageous to the non-dollar countries to have their currencies firmly linked to the dollar? This link has ensured that every upward or downward movement of the volatile American economy has been communicated to the European economies. In the summer of 1949 the inventory recession in the United States caused the decline in demand for imports which led to the revaluation of sterling and all the soft currencies. Would it not have been better if the decline in American imports had been met by the steady depreciation of the soft currencies? Later, in the second part of 1950 and in 1951, the primary commodity inflation caused by American stockpiling turned the terms of trade sharply against the industrial countries. The United Kingdom suffered heavily as the deterioration in her terms of trade caused her balance of payments to become adverse, while the rise in her import prices gave a fresh fillip to domestic inflation. Both the United Kingdom and the OSA would have been spared much if (subject to the approval of the latter) sterling had been allowed to appreciate slowly to the peak of the inflation (while the OSA still had a dollar surplus and the demand for sterling was in excess of the supply) and then to depreciate as the inflation subsided. The initial appreciation would have protected the British price level from the more extreme effects of rising import prices, while the subsequent depreciation would have reduced the shock to the OSA of the sudden drop in American demand as the boom collapsed. In one respect the demands made for sterling revaluation in early 1951 may be viewed as a rebellion against the rigidity of the fixed-rate system. The fact that if such a revaluation had taken place in the spring of 1951 it would have had short-lived benefits and would have intensified the United Kingdom's embarrassment in the autumn of that year strengthens rather than weakens the case for greater freedom of rates. For such rapid swings in relative prices the system of managed flexibility is unsuited, and there is much to be said for a method of foreign balance adjustment which is progressively invoked as imbalance develops.

The arguments for and against a system of flexible rates are, it

will be seen, finely balanced. In particular the elasticity condition calls in question the short-term value of rate changes, and there are those who claim that this in itself is sufficient to prevent their adoption. Yet one may wonder whether too much weight is not given to the condition. We do not know how elastic the demand for imports really is in the absence of controls. Moreover, we must remember that in so far as conditions of supply are inelastic, as they are likely to be in a fully employed world, the condition is weakened. To the writer it seems that, in the main, the balance of advantage lies with flexible rates, provided they are accompanied by certain safeguards. There is no reason why a system of flexible rates should not be accepted by the Fund and embodied in its charter.¹ The position of the Fund would not be impaired, but might well be strengthened in the long run, for the Fund in its present state has everything to gain from a more daring and experimental policy. Three qualifications must, however, be made to the advocacy of a free-rate system. First, since day to day fluctuations of the rates would presumably be under the influence of national stabilisation funds, certain principles for the operation of these funds should be embodied in the Fund's charter. These would be necessary in order to guard against the possibility of such fund operations being aimed at competitive manipulation of the rate. Second, rates should be allowed to fluctuate only over a stipulated range² (defined as a given percentage). Thus it would be necessary for a country to take appropriate domestic action should its exchange rate fall or rise to the limits of depreciation and appreciation respectively. As was pointed out in Chapter 4 the greatest danger of flexible rates of exchange may prove to be the inflationary thrust which they exert on the domestic price level via the changing terms of trade. For this reason there should be clearly

¹ On June 15, 1954 the Fund adopted a set of rules designed to cover the operating problems created by the existence of a number of members (e.g. Canada, Peru) who allow exchange rates in their markets to fluctuate in such a way that exchange transactions in their currencies are not based on parity in accordance with Art. IV, sec. 3 of the Fund Agreement. These rules make it possible for the Fund to deal in these currencies and they facilitate the periodic revaluations of the Fund's holdings of these currencies. These rules are, it is emphasised, intended to be experimental. Cf. *Annual Report of IMF for 1955*, pp. 87-8 and Appendix II, pp. 125-7.

² It would be unwise to hazard an estimate of what such limits should be. They would obviously vary from country to country. A possible scheme would be for countries to submit their proposals to the Fund as they did their initial parities and for the Fund to scrutinise them and negotiate with member countries accordingly.

TABLE IV
Currency Transactions of the IMF
 (\$ mln)

	1 Mar. 1947 to 30 June 1947	1 July 1947 to 30 April 1948	1 May 1948 to 30 April 1949	1 May 1949 to 30 April 1950	1 May 1950 to 30 April 1951	1 May 1951 to 30 April 1952	1 May 1952 to 30 April 1953	1 May 1953 to 30 April 1954	1 May 1954 to 30 April 1955	1 May 1955 to 30 April 1956
<i>Sold to members by the Fund</i>										
United States Dollars -	56	544	108.03	51.8	—	46.25	66.125	69.25	48.75	38.75
Pounds Sterling -	6	—	—	—	28	—	—	157.64	—	—
Belgian Francs -	—	—	11.41	—	—	—	—	—	—	—
German Marks -	—	—	—	—	—	—	—	4.4	—	—
Total Currency sold -	62	544	119.44	51.8	28	46.25	66.125	231.29	48.75	38.75
<i>Bought from members by the Fund</i>										
Pounds Sterling -	—	300	—	—	—	—	—	—	—	—
French Francs -	50	75	—	—	—	—	—	—	—	—
Belgian Francs -	—	33	—	—	—	—	—	—	—	—
Netherlands Guilders -	12	56.5	6.85	—	—	—	—	—	—	—
Danish Kroner -	—	10.2	—	—	—	—	—	—	—	—
Norwegian Kroner -	—	5	4.56	—	—	—	—	—	—	—
Australian Pounds -	—	—	10	20	—	—	30	—	—	—
South African Pounds -	—	64.3	98.03	31.8	28	46.25	36.125	231.29	48.75	38.75
Others -	—	—	—	—	—	—	—	—	—	—
Total Currency Bought	62	544	119.44	51.8	28	46.25	66.125	231.29	48.75	38.75
Cumulative Total -	62	606	725.44	777.24	805.24	851.49	917.615	1148.905	1197.655	1236.405

defined points at which appropriate domestic compensating action should be initiated by the government. And third, the flexible exchange rate must be accompanied at all times by a domestic credit and fiscal policy designed to give support to the rate. There must be no mistake: the rate of exchange cannot alone assume the role of adjuster of the balance of payments. It may bear the bulk of the weight and save the domestic economy from price and income adjustments of such magnitude as would be detrimental to stability and employment, but it must be recognised that, without jeopardising domestic stability or full employment pledges, it is possible to practise domestic policies which will give the rate support. There should, for example, be no question of allowing the rate to depreciate to its lower limit before taking remedial action.¹ That limit should be regarded as an extreme position to be held at all costs, and progressively potent action should be taken to prevent the rate from falling to the lower limit.

TABLE V
IMF Transactions in U.S. Dollars

U.S. quota under articles	-	-	-	2,750 <i>mln</i>
² Paid in gold	-	-	-	687,500,000
Paid in U.S. currency	-	-	-	2,062,225,000
³ Paid in U.S. currency	-	-	-	275,000
				<hr/> 2,750,000,000
Total U.S. dollars available for currency transactions	-			2,062.225 <i>mln</i>
Sales of U.S. dollars to members for their own currencies, March 1, 1947 to April 30,				
1956	-	-	-	1029.0
Sales of U.S. dollars to members for gold	-			<hr/> 6.2
Total dollar sales	-	-	-	1035.2
Amount paid to Fund in dollars under repurchase arrangements	-	-	-	<hr/> 789.5
Net reduction in Fund's dollar holding	-	-	-	<hr/> 245.7 <i>mln</i>
Present dollar holding	-	-	-	<hr/> 1,816.525 <i>mln</i>

¹ Nor should it be imagined that a flexible rate allows a country to tolerate inflation at home. There could be no greater stimulus to hyper-inflation than uncontrolled domestic over-employment and a free rate of exchange.

² Under Article III, sec. 3 (b).

³ Under Article XX, sec. 2 (d), 1/100th of 1 per cent of a member's subscription was to be paid in gold or U.S. dollars for the purpose of meeting the administrative expenses of the Fund.

(c) Table IV gives a summarised account of the Fund's currency transactions from the beginning of its operations on March 1, 1947 to April 30, 1956. As will be seen almost the whole task of the Fund has been to sell dollars. Table V shows the effect upon the Fund's dollar holding of these transactions. Approximately 50 per cent of the Fund's original stock of dollars had been sold by April 30, 1956 about 53 per cent of the sales being concentrated in the period between July 1, 1947 and April 30, 1948. Most of these sales were to Western European countries, notably the United Kingdom, France, Holland and Belgium. This was the period immediately preceding the European Recovery Programme and was one of chronic imbalance for the European countries.¹ These dollar sales were partially offset by dollars received from members in the repurchase of their own currencies. On April 30, 1956 the Fund's dollar holding was some 66 per cent of the original United States quota.

It may appear at first sight that, considering the magnitude of the dollar problem since the war, drawings upon the Fund's dollar resources have not been great, but it should be remembered that the Fund was 'cushioned' in 1947 by the United States' and Canadian Loans to Britain; in 1949, 1950 and 1951 by the European Recovery Programme, and later by defence aid so that the demand for its dollars has been potential rather than actual. Had demands upon it been continued at the rate of \$600 mln per annum, as in the year from mid-1947 to mid-1948, its dollar resources would soon have been exhausted. Actual sales of dollars during the past nine years give little indication of the burden which would fall upon the Fund in a world in which (apart from national reserves) there were no other sources of relief.

The Fund made an early declaration of policy with regard to the use of its resources. At the Inaugural Meeting the Board of Governors had requested an interpretation of the Articles of the Fund in this matter, showing particular interest in whether the 'authority of the Fund to use its resources extends beyond current monetary stabilisation operations to afford temporary assistance to members in connection with seasonal, cyclical, and emergency fluctuations in the balance of payments of any member for current

¹ For example Britain purchased \$300 mln from the Fund. This was to tide over the period between the exhaustion of the United States' Loan and the beginning of Marshall Aid.

transactions and whether the Fund has authority to use its resources to provide facilities for relief, reconstruction or armaments, or to meet a large or sustained outflow of capital on the part of any member'. This query evoked the following statement of policy on September 26, 1946;

'The Executive Directors of the IMF interpret the Articles of Agreement to mean that authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilisation operations.¹

During the five years that followed the Fund curtailed the use of its resources. The dangers of operating on a large scale during reconstruction had been realised and it had been decided by the Fund not to provide facilities for relief and rehabilitation — this being the function of UNRRA. This did not mean, however, that members were debarred from using the Fund's resources because they were importing capital goods for postwar reconstruction. The magnitude of a member's drawings on the Fund and the balance of payments position of that member were to be the relevant criteria of judgement. The Fund thought it desirable to assume this risk in order that it might contribute to the maintenance of national economies and of exchange stability during the transitional period, but by 1948 the heavy calls made on its dollar holdings forced it to weigh the advantages to itself and its members of conserving its resources for use in the post-transitional period, against the advantages which members could derive from their immediate use. Considering the unsettled character of international conditions the Board was forced to the conclusion 'that in some doubtful cases there were in general more disadvantages involved in denying members access to its resources than in allowing them such access'.² Applications for assistance were thereafter considered on their merits.

With the inauguration of the European Recovery Programme in 1948 the burden of demand for dollars was lifted from the Fund, who made it known 'that ERP members should request the purchase of United States dollars from the Fund only in exceptional

¹ Cf. *Report of the Executive Directors and Summary Proceedings*, September 27 to October 3, 1946, p. 106.

² Cf. *Annual Report of IMF for 1948*, p. 47

or unforeseen circumstances'.¹ This was hailed by many as a partisan decision reflecting the American influence upon the Fund but in the circumstances it was not unreasonable and the Fund's wisdom in conserving its dollar resources is hard to question. Later, the coming of North Atlantic rearmament and the renewed trade deficits for member countries placed the Fund in a new dilemma. It was argued by some countries that, as an economic institution set up by the North Atlantic powers, the Fund should utilise its resources to meet such external disequilibria as were caused by defence expenditure,² and that, to this end, the 1948 'standstill order' should be revoked. But this was not the view of the Fund which interpreted its function as primarily to lead the way back to free and multilateral trade and only secondarily to supply scarce currencies to members. For this reason it decided to stand aloof from rearmament and urged member governments to pursue policies which would make possible the Fund's desired return to multilateralism.

In 1951, as the Fund neared the end of the transition period, its efforts were 'concentrated on the formulation of policy respecting the use of resources in the less disturbed payments situation' which it was hoped lay ahead³ and the Executive Board approved a proposal designed to ensure that the Fund's resources would be made available to give confidence to members in undertaking practical programmes of action to help achieve the purposes of the Fund Agreement⁴ — such programmes to be the subject of consultations between members and the Fund. One of the features of the scheme was that the Fund had to ensure that the use of its resources would be temporary.⁵ At the same time the Fund became more militant in its attitude and it informed its members that its resources would in future be available only on certain conditions, that countries should adopt anti-inflation programmes and should progressively relax or remove trade restrictions.⁶ Here again

¹ Cf. *Annual Report of IMF for 1948*, p. 49.

² This view was put forward by one of the British representatives (Sir Leslie Rowan) at the Washington meeting of the Fund in September 1951.

³ Cf. *Annual Report of IMF for 1951*, p. 81.

⁴ *ibid.*, p. 81.

⁵ To achieve this it reduced in December 1951 from $\frac{3}{4}$ to $\frac{1}{2}$ per cent the flat service charge levied on all currency sales to a member and lengthened the period during which a loan of a currency incurs no further charge from three to six months. After six months the charge was to be raised from $\frac{1}{2}$ to 1 per cent and raised by $\frac{1}{2}$ per cent every six months and not every year as formerly.

⁶ Cf. Mr. Ivar Rooth's address to the Annual Meeting in September 1951. *Summary Proceedings. Sixth Annual Meeting*, 1951, p. 13.

it is worth noting that the Fund's change of policy coincided with widespread and clamant demands in the United States that Western European countries should end the inflation in their economies by the pursuit of appropriate domestic policies. At the Sixth Annual Meeting of the Board of Governors in September 1951 several Governors criticised the scant use which was being made of the Fund's resources and in its *Annual Report for 1952* the Fund gave a lengthy statement of its policy for the supply of currencies, reproducing for the purpose a decision of the Executive Board of February 13, 1952. It was claimed that two factors underlay the policy statement: the change in the world payments situation, including the reduction and reorganisation of American foreign economic aid and the necessity to safeguard the revolving character of the Fund's resources.¹ The policy statement expanded the policy outlined in the 1951 Report. No member was to be denied access to the Fund's resources because it was in difficulty. This, however, conflicted with the heavy emphasis upon the temporary nature of the assistance. Three to five years was to be regarded as the outside time-limit for repayment and in certain cases repayment arrangements and times would be agreed as a necessary preliminary. In deciding whether a given request for assistance would be granted the Fund would have regard to two factors: the economic policies of the applicant and their value in dealing with the deficit, and its past record with the Fund.²

An interesting innovation was the inauguration of 'stand-by arrangements'. These had been provided for in the statement of February 13, and in response to a request by Belgium the Fund agreed on June 19, 1952 to grant Belgium the right, for a period of six months, to purchase with Belgian francs on a revolving basis up to \$50 mln in currencies held by the Fund. Such stand-by arrangements were to be negotiable between the Fund and individual members. In considering requests from members for stand-by accommodation the Fund applies the same tests and standards as are applied to requests for immediate drawings but once a stand-by credit is granted the request of a member for ac-

¹ The Fund was at this time concerned at the slowness with which the repurchase provisions were operating. It was coming to favour currency loans with a fixed date of repayment in preference to reliance on these provisions to replenish its stocks of hard currencies.

² Particularly with regard to the honouring of repurchase obligations and the furnishing of information to the Fund.

accommodation can only be refused if (a) the ineligibility provisions of the Fund have been invoked, or (b) the Fund has decided to suspend transactions generally. It was hoped by such arrangements to create a condition whereby members 'for a given period of time might be able to rely on the Fund's resources to meet a current account deficit' in their balance of payments. But the Fund made it clear that 'stand-by arrangements should serve as an instrument for the advancement of the Fund's purposes'. The assurance of Fund help was to enable members to meet calls upon their reserves without resorting to restrictive practices, and stricter conformity to Fund objectives was to be looked for. In short, once more assistance was to be conditional. It was hoped that as the transition from a period of relatively modest use of the Fund's resources to one of more active use was made, experience would be built up and member governments would come to know and understand the criteria upon which assistance from the Fund would be forthcoming. Nevertheless, there was to be no question of automatic access to the Fund's resources.¹ The Fund was still to proceed on a 'case-by-case' basis. The sole advantage to be derived from stand-by arrangements is that by their use countries may know for certain and in advance whether assistance will be forthcoming from the Fund.

It is in the Fund's policy with regard to the supply of international liquidity that American political influence has been most noticeable. Every request by a member for accommodation has been carefully scrutinised and, in later years, made subject to the pursuit of certain policies by the suppliant member — these policies bearing striking identity with official utterances of the American Treasury. Although the decision by the Fund in 1948 to withhold its support from countries in receipt of Marshall Aid was reasonable enough, it was undoubtedly taken under American pressure and seemed to embody the view that while one form of

¹ With one possible exception. It was promised that when the members' drawings did not increase the Fund's holdings of its currency beyond an amount equal to its quota the members could expect to receive "the overwhelming benefit of any doubt" which might arise in connection with requests to make such drawings. The fact that the Fund's holdings of a member's currency might be less than its quota is, of course, because part of the quota is payable in gold. The difference between quota and currency holding is referred to as the 'gold tranche'. Later in 1955, the Fund added that within the first credit tranche (i.e. above 100 per cent but not over 125 per cent of its quota) its attitude towards applications for drawings would be a liberal one. Cf. *Annual Report of IMF for 1955*, p. 85. This promise has been honoured by the large drawings and stand-by arrangements granted to Britain and France in 1956.

American charity was being dispensed all others should cease. There has been throughout a strong savour of American paternalism rather than international co-operation motivating Fund decisions.

The 'Keynes view' of the Fund as a large and replenishable stock of currencies to which member nations would have automatic access, of the Fund as an international lender of last resort, has been replaced by a totally different conception. So far as the supply of currencies is concerned the Fund construes its function as one of meeting temporary disequilibria in members' balances of payments by conditional short-term advances. Two considerations must be paramount: the advance must be temporary and subject to the Repurchase Provision of Article V, sec. 7, and it must expose the Fund to the minimum of risk. The application of these principles in practice demands that the Fund be in a position to judge whether or not a given disequilibrium is likely to be temporary in character or not — a judgement which in most cases is not easy to make. Only rarely is a balance of payments deficit temporary and self-correcting. When it is not so the Fund would have to decide what corrective measures were appropriate and whether or not the government of the country concerned was likely to undertake them.

Precluded by its Articles from giving assistance to meet a 'fundamental disequilibrium' and making advances only in accordance with these twin liquidity principles of short-duration and minimum risk, one feels inclined to ask: in what unique circumstances will the help of the Fund be given? If it is replied: only when the disequilibrium is temporary, when correction is assured and when repayment follows hard upon correction, then we must retort that such circumstances are rare and are precisely those in which countries will prefer to use their own reserves. Thus the Fund yielding little in advantage, gains little in influence. Only when it has benefits to offer will it have power to wield

There can be little doubt that a more open-handed policy in the provision of currencies would have benefited the Fund as well as its members. The necessity for large reserves of international liquidity has been and is great. In 1951 the total reserves of countries other than the United States were smaller relative to the volume of trade than they were before the war. In mid-1951 total gold and official dollar holdings were only 20 per cent higher than in 1937 — while total imports (in dollar terms) ran at two-and-a-half times

those of 1937 — largely the result of higher prices. In 1955 official reserves (outside the United States and the Soviet Area) were only 42 per cent of the value of imports. If this paucity of liquid reserves is coupled with the fact that many countries are now committed to full employment policies and cannot counteract external deficits by allowing their income and employment levels to fall, it will be seen that a greater and not a smaller world stock of liquidity is necessary. Moreover, the existing world stock is ill-distributed; some countries in Europe having reserves equal to less than 25 per cent of the value of annual imports and some even less than 10 per cent. Such a condition is inherently unstable. A suspected devaluation of a currency, by delaying payments for exports and advancing payments for imports by one month would cause a drain on the reserves of the deficit country equal to two months' imports. The swift drain of Sterling Area reserves in the autumn of 1949 should be remembered. There have, however, been indications that the Fund is at last moving towards a more liberal view of the use of its resources, and in 1953-54 it expressed willingness to make its resources available to members either for temporary balance of payments deficits or as part of a programme to secure exchange convertibility and the removal of restrictions. The Fund has promised that it is giving further consideration 'to the development of a consistent and well-defined policy on the use of its resources that will aid members in making their own policy decisions'.¹

Nevertheless the IMF at present makes a pitifully small contribution to the stock of international liquidity. This is only in part due to its cautious lending policy. Its resources are far too small to deal adequately with the sort of balance of payments fluctuations which occur. Small in 1944 they have now lost all workable relation to the conditions of a world in which the level of prices has risen steadily since that time. When the supply of United States dollars runs at approximately \$20,000 mln per annum (exclusive of military aid) the ineffectiveness of the Fund's \$2,800 mln to deal with fluctuations in this flow can hardly be questioned.² Means must be found to increase the Fund's resources and the policies

¹ Cf. *Annual Report of IMF for 1954*, p. 102, and *Annual Report of IMF for 1955*, p. 85.

² A United Nations Committee has estimated that a reduction in dollar supply of the same relative severity as that of 1937 and 1938 (even if followed by quick recovery) would mean a reduction of as much as \$10,000 mln in the supply of dollars over the two years of decline and recovery. Cf. *Measures for International Economic Stability*, United Nations 1951, pp. 34 and 42.

according to which the Fund lends to its members must be scrutinised and overhauled. Means whereby this might be done will be our concern in Section III of this chapter. Meanwhile, the Fund regards its resources as adequate, and an 'increase in its resources is not a question for action at the present time'. They form secondary reserves and countries must depend on their own national reserves and follow 'financial policies that will enable them to build up reserves in periods of prosperity which would provide a first cushion to absorb the shock of a recession'.¹

Finally, a word may be said on the repurchase provisions. These were designed to secure that the Fund be reasonably liquid in all currencies and that widespread demands for the purchase of one or two currencies should not leave the Fund choked with 'soft' currencies. In principle the provisions (Article V, sec. 7) provided that members who had made a purchase of currency from the Fund should repurchase their own currency with gold or dollars, the rate of such repurchase being conditioned by the subsequent size and fluctuations of the member's reserve. This provision served not only to reimburse the Fund but to ensure that members should not augment their reserves by drawing upon the Fund. A number of 'waiver conditions' were, however, inserted in the repurchase obligations, the most notable of which provided that the repurchase obligations of a member should remain in abeyance as long as the member's monetary reserves remained smaller than its Fund quota.²

Repurchase of currencies from the Fund began in May 1949 and by April 30, 1956 twenty-nine countries repurchased excess Fund holdings of their currencies amounting to \$168.4 mln in gold and \$789.5 mln in convertible currencies. This should be related to the Fund's total exchange transactions with thirty-two countries up to the same date of \$1,242.6 mln. The main difficulty which seems to have been experienced in the working of the provisions is the time-lag which must elapse before repurchase takes place. This is not necessarily due to the tardiness of members but to the slowness of obtaining data on reserves and of determining members' repurchase obligations.³

¹ Cf. *Annual Report of IMF for 1952*, p. 46. In January, 1956 the Fund completed its quinquennial review of quotas required by Article III, Sec. 2 of the Articles of Agreement and did not propose any general revision.

² For a good discussion of the *modus operandi* of the repurchase provisions see W. A. Brown, 'The Repurchase Provisions of the IMF', *American Economic Review*, March 1945.

³ Cf. *Annual Report of IMF for 1949*, p. 46.

It seems probable that, if the Fund were to extend the scope and magnitude of its currency transactions, the present repurchase arrangements would not be adequate to ensure the necessary turn-over of its resources. The arrangements are, however, capable of being simplified and strengthened by the inclusion in each currency transaction of specific contractual repayment arrangements — a procedure which has already been adopted in certain cases.

A criticism which has been made in some quarters is that the repurchase obligation, by compelling members to repay in gold or convertible currencies, may often have deterred members from buying currencies other than dollars from the Fund.¹ It is impossible to decide whether this has in fact been the case, but it should not be difficult for the Fund to consider applications to allow repayment in the currency borrowed.²

(d) The Fund's functions in regard to gold are three. First, since gold remains an international means of settlement the Fund undertakes to make certain transactions in gold. Of these the most important are the right of members to purchase currencies from the Fund for gold,³ and the obligations of members to repurchase the Fund's surplus holdings of their own currencies for either gold or dollars. Second, it undertakes to perform services which will economise gold movements. It can, for example, arrange the exchange of gold in one centre for gold in another with resultant saving of shipping costs.⁴ And third, it supervises the sale of gold by member countries to see that all sales are at prices according with the parity of the currency concerned.

¹ Cf. *Measures for International Economic Stability*, United Nations 1951, p. 38, and 'The International Monetary Fund,' R. F. Mikesell, *Journal of Political Economy*, October 1949.

² Prof. J. H. Williams attaches great importance to the obligation of member countries to repurchase their currencies from the Fund in dollars, whether the original currency bought from the Fund was dollars or not. Only by such a device, Williams argues, could chronic dollar shortage be prevented. The dollar is a key currency and since the United States pays for its imports in dollars it has no need to purchase other currencies from the Fund. Moreover, much trade between third countries is financed in dollars. So far as the Fund is concerned the dollar is eternally in demand but in fixed supply. There is a danger that the Fund's original dollar holding should be depleted and that countries would hold stoutly to their dollar balances. This difficulty is in part met by the repurchase provisions which ensure that part of these dollar balances will go to the Fund. Cf. J. H. Williams, *Postwar Monetary Plans*, p. lxx.

³ Cf. Article V, sec. 6 (a) of Fund Agreement.

⁴ For example the Fund received more gold at New York than it was permitted to hold initially under the Fund Agreement, but the Fund was able to give gold in New York to two members against the delivery of an equal quantity of gold to the Fund in London, thus helping the members and placing its own gold holdings in accord with the Fund Agreement.

Little need be said of the first of these functions. From members quota subscriptions the Fund acquired an initial gold stock equivalent to \$1,344 mln which it held at depositories in various centres.¹ Nineteen members paid the gold part of their subscriptions on the basis of 25 per cent of quota and eleven paid on the basis of 10 per cent of official holdings of gold and United States dollars as at September 12, 1946. Since beginning exchange transactions the Fund has (to April 30, 1956) supplied currencies in exchange for gold to the value of \$6.2 mln and its gold stock was increased in value by \$168.4 mln paid by members for the repurchase of their own currencies from the Fund. At April 30, 1956 the value of the gold held by the Fund was \$1,761.362 mln.

To perform the second of the above tasks the Fund on March 21, 1952 set up a Gold Transactions Service designed to provide members with a regular technical service in connection with their gold transactions. Members wishing to buy or sell gold through the Fund were asked to provide the Fund with necessary information in confidence and the Fund would then seek to put buyers and sellers in touch with one another. For this service the Fund exacts from each partner the charge of $\frac{1}{32}$ and of one per cent payable in dollars. By the end of April 1956, fifty-five transactions involving a total of \$447 mln had been completed through the Fund's service.

It is the third aspect of its gold policy that has caused the Fund most concern. Pledged to the promotion of exchange stability it deemed it its task to discourage external purchases or sales of gold at prices which, directly or indirectly, produced exchange transactions at depreciated rates. The par values of all members' currencies are expressed in terms of gold and the Fund has sought to prevent external gold transactions at prices diverging from the official parities. Private gold transactions made in United States dollars were reported from time to time at premiums of over 40 per cent and on June 18, 1947 the Fund circulated to all member countries a statement pointing to the danger to exchange stability of a growing volume of gold transactions at prices which produced exchange dealings at depreciated rates. The Fund recommended that all of its members should take effective action to prevent such gold transactions with other countries or with the nationals of

¹ Namely New York, London, Shanghai, Paris and Bombay.

other countries. Members responded to the Fund's appeal. Some (including certain of the leading gold producers) stated that their practices were in accord with the Fund's policy, and some that their gold sales had been authorised before the Fund had defined its policy. All said they were willing to conform to the Fund's wishes, and Canada, the United States, and the United Kingdom tightened their controls over gold dealings.¹

Balance of payments difficulties led countries after the war to encourage gold production. On December 11, 1947 Canada announced a programme involving a subsidy on increases in production as compared with a base year. Although it grudgingly approved the Canadian scheme² the Fund took the view, however, that a subsidy in the form of a uniform payment per ounce constituted an increase in price so that the price no longer conformed to the official parity and it issued a general policy statement³ asking members to consult with it before instituting measures to subsidise gold production. In March 1948 the Australian Government submitted a scheme for assisting gold mining in Western Australia to the Fund who approved it⁴ on the ground that it did not threaten exchange stability.

In its 1949 Report the Fund continued to express dissatisfaction with the way in which certain member countries tolerated premium sales and it also issued a warning as to the speed with which gold was disappearing into private hoards. According to a Fund estimate not less than \$200 mln was finding its way annually from newly-mined gold stocks and central holdings into private hoards. Much of this seepage was being caused by the sale of semi-processed gold and in 1949 the Fund conferred with the Government of South Africa as to the best means of controlling the trade in

¹ In spite of this favourable reaction to its request the Fund in its *Annual Report for 1948* (p. 41) stated that there was 'ample room for greater support of the Fund's policy'. In March 1951 the Executive Board again complained that the arrangements of some countries that sell gold at premium prices 'are no longer a satisfactory basis to implement the Fund's gold policy'. The subject was also discussed at the 1951 Annual Meeting in Washington.

² Cf. 'Fund's Statement on the Canadian Government's Proposed Gold Production Subsidy', Press Release, December 11, 1947. *Annual Report of IMF for 1948*, Appendix VII, p. 81.

³ Cf. *Annual Report of IMF for 1948*, Appendix VI, p. 79.

⁴ The Australian Government's scheme was designed to enable certain marginal mines to continue operations despite rising costs so as to maintain the population of certain remote areas solely dependent upon the gold mining industry.

semi-processed metal and certain safeguards were agreed upon.¹

The root of the difficulty lay, of course, in the low price of gold. Under present conditions of dollar scarcity this is determined by the official buying price of the United States Treasury which has remained at \$35 per ounce since 1934. Meanwhile all other prices have risen and the payments positions of the gold-producing countries have deteriorated. In 1948 newly-mined gold could pay for, in real terms, less than one third as much import goods as in the period 1938-40. Moreover, in the gold-producing industry costs had soared; this, with the unchanging selling price, causing serious shrinkage of profit margin. World gold production, which had fallen by nearly 50 per cent by 1945 as compared with 1940 was very slow to recover and, both on payments grounds and on grounds of survival of the industry, it is not surprising that sales at premium prices were taking place and that, in some cases, the governmental counter measures were somewhat half-hearted. The Fund, intent on a rigid maintenance of the official parities, was hostile to both premium sales and to the subsidies by means of which some governments were trying to support producers.

An increase in the price of gold has been continually advocated in certain quarters as a means of alleviating balance of payments difficulties and stimulating gold production. Such an increase would, it is argued, write up the value of existing national reserves, give relief to the balances of payments of gold-producing countries who have too long been afflicted with a special terms of trade problem, remove the encouragement to hoard gold or to sell it at premium prices and would benefit indirectly countries exporting mainly to gold-producing countries. Such a change of price cannot, however, be made unless the United States government agrees. A uniform proportionate change in the Fund's par values is allowed by Article IV, section 7 of the Agreement, if it is approved by a majority of the total voting power of the Fund including every member who has 10 per cent or more of the total quotas. The passing of such a measure would then be contingent on United States approval and this would certainly not be given. The main effect on the United States of an increase in the price of

¹ Cf. 'Statement by the Managing Director on Consultations with the Union of South Africa'. Press Release of May 11, 1949. Quoted in *Annual Report of IMF for 1949*, Appendix VI, p. 63.

widespread premium gold sales in defiance of its demands to maintain even the pretence of clinging to its former policy. On September 28, 1951 the Fund issued a policy statement¹ in which it admitted that 'A continuous study of the situation in gold producing and consuming countries shows that their positions vary so widely as to make it impracticable to expect all members to take uniform measures in order to achieve the objectives of the premium gold statement.' This represented a virtual striking of the Fund's flag on this front. Once again its authority had proved ineffective in enforcing what it believed to be the right policy. In this, as in other trials of strength, the Fund lost greatly in prestige. Within a few days of the publication of the Fund's policy statement gold prices fell in all the premium markets. By April 30, 1952 the price had declined to about \$37 per ounce. Many countries relaxed their restrictions upon the sale of gold and the movement of gold through their territories.² The London Gold Market was reopened in March 1954 and from that time the Union of South Africa prohibited its gold producers from selling their output in free markets. All future sales were to be made through the South African Reserve Bank which was to sell as much of its gold as possible on the London Market.

(e) Of the Fund's remaining functions two are noteworthy: the facilities and means which have been established for consultation between the Fund and its members, and the relations which it has established with other international agencies.

Although left to this late stage of our discussion, it is not an exaggeration to say that the gradual evolution of techniques of consultation with members is among the most important tasks of an international monetary authority. Once effective links have been forged between agency and members, once members regard the agency as a potent and knowledgeable leader of international monetary policy, a great and significant step has been taken. Once members come to regard such an agency as representing a sectional viewpoint, or consider it desirable to by-pass its authority in the formation of policy measures, then the agency is doomed to a carping obscurity and the supply of nagging criticism in a spirit of dutiful self-assertion. Whether the Fund assumes the role

¹ Cf. *Annual Report of IMF for 1952*. Appendix IV, p. 95.

² For an account of this general relaxation of controls see *Annual Report of IMF for 1954*, pp. 118-21.

of active leadership, or whether, fifty years hence, the historian of the international economy thinks it worthy of mention, is a matter still in the balance but likely to be decided soon.

There are two aspects of the Fund's consultative work. First, there is the purely technical task of providing member governments with advice and information. So far as can be judged by the outsider this task has been tackled energetically and methodically and much useful work has been done. Technical missions have visited countries at their own request in an advisory capacity and help has been given with the monetary problems of many countries — particularly those where monetary institutions and techniques are immature. A steady flow of information and statistics relevant to international trade and payments is provided by the Fund's publications.¹ The second aspect of consultation is the more important, that of agreeing with members on the interpretation and day to day application of the Fund Agreement and of evolving agreed policy principles. For this purpose the Fund argues² that, with the Executive Board continuously in Washington and meeting frequently, adequate machinery for discussion between members and Fund is assured. This is supplemented by staff visits to member countries and the stationing of staff members in Paris, Cairo, and Bombay. Whether or not such machinery is truly effective is open to question but the existence of other over-riding considerations makes discussion of this point superfluous. It would only be necessary to consider the adequacy of the consultation machinery if member states wished to consult with the Fund. But they do not. We must face the fact that, for the greater part, members have, where possible, dispensed with the Fund's advice. Seeking only to satisfy the appearances of conformity with the Fund Agreement, they appear well content if left alone by the agency. It cannot after ten years be said that the Fund has acquired the prestige and international standing which Keynes regarded as a pre-requisite of its success.

For this decline in stature there are probably several reasons. Undoubtedly member nations lack confidence in the Fund. For

¹ These are: the *Monthly Bulletin of International Financial Statistics* (since 1948); *Direction of International Trade* (jointly with IBRD); the *Balance of Payments Yearbook*; the *International Financial News Survey*, a weekly digest and the Staff Papers, published three times a year and containing research material and articles by members of the Fund's staff.

² Cf. *Annual Report of IMF for 1949*, p. 48.

this the Fund and the Americans bear heavy responsibility, for it is the Fund and not the system which is felt to have failed. There is criticism of the Bretton Woods scheme of international payments but no lack of confidence that, with modification, it can be made to work efficiently. Experience has mellowed opinions yet it has not fundamentally changed them. But the Fund itself has in the eyes of its members cut a poor figure. The obvious influence of the American Treasury upon its policies and utterances, its determination to supply currencies only on conditions, and the growing realisation that its resources are inadequate for present needs, have all fostered the view that the Fund has no contribution to make to the solution of international problems. These deficiencies have already been discussed in their place. When they are met, it is likely that the consultative aspect of the Fund's work will spring to prominence and methods of consultation can be perfected.

Lastly, it has been the task of the Fund to establish and maintain contact with other international planning agencies. Although the ITO, whose functions were to be complementary with those of the Fund has not been established, postwar events have thrown up a number of international organisations, mostly of an *ad hoc* character. Many of these tend to overlap in their functions and some, notably the OEEC, detract from the originally intended sovereignty of the Fund. With its twin the World Bank, the Fund maintains close contact through Joint Committees of the Board of Directors. Under an Agreement of 1947 there exist certain arrangements for discussion of mutually interesting questions with ECOSOC, and correspondence in September 1948 defines the spheres of influence and contacts of the Fund and GATT. Even with these arrangements the Fund has referred more than once in its reports to problems of overlapping jurisdiction. There has been evidence from time to time that instead of forming a group of functional agencies under the United Nations each of the international bodies has sought to create its own sphere of influence and hold it against all comers. To this the tentative and experimental character of the incorporating documents has contributed greatly. Moreover, on more than one occasion difference of opinion between the agencies on policy matters has been evident.¹

¹A good example occurred in connection with the proposal in 1951 of certain economists to revalue the pound. The ECE advocated revaluation, the Fund was hostile while the BIS was favourable but guarded. One cannot escape the feeling that, had any action been taken, it would have been decided over the heads of all three.

III

Before concluding this examination of the Fund it is necessary to draw from the preceding record of its activities such lessons as may serve to shape its future, and rescue it from the obscurity into which it has sunk. We will confine ourselves to enumerating only the main conclusions reached and the nature of the reforms which might be made.

(i) The Bretton Woods system with the Fund as its institutional centre represents a valuable co-operative element in the international economy, and an advance from the condition of freedom bordering upon anarchy which preceded it. Now that it is established the Fund forms a nucleus around which further co-operative efforts can centre. Its abandonment, either formally or by tacit agreement, would be retrograde.

(ii) Although any plea for the reform of the Fund should undoubtedly be headed by the demand that it should discard the present system of government by permanent executive directors in favour of one suited to its role as an international monetary agency, it is of little use advocating such a step.¹ The overwhelming economic and military dominance of the United States, the unassailable right which she has to choose the means of dealing with her great export surplus, and the location of the Fund's headquarters in Washington, all ensure that such reforms as may be necessary in the Bretton Woods system will have to be executed within the present administrative framework and system of control.

(iii) The Fund has so far limited its activities and this, together with the rise of other international economic agencies, has robbed the Fund of the position of influence and prestige for which its founders hoped. Its position in the future could still be secured, however, by making its working more automatic. This could be done with three changes: first, the present system of fixed parities should be abandoned for one in which member nations allow their currencies to fluctuate in value over a range, the magnitude of all such ranges to be notified to and approved by the Fund; second, the Fund should stand ready to supply currencies to its members without conditions (save where a member has already exhausted its drawing rights) but at such rates of interest and charges as it may see fit to impose; and third, the Fund should

¹ Proposals for the reform of the directorate were made by Canada at the Annual Meeting in September, 1956 but with no result.

be prompt in declaring a currency scarce when it becomes so. In addition the use of stand-by credit arrangements should be extended. The Fund should, in fact, fulfil the international role of lender of last resort, standing always ready to lend but at a penal rate. With this greater automaticity in the Fund's working there would be less scope for political influence and, provided its machinery were adequate, it might hope for the success which has attended the EPU. The two conditions of successful automatic working are an adequate system of international adjustment for balances of payments and an adequate supply of international liquidity. These must be assured, the former by the use of a system of flexible exchange rates, the latter by an expansion of the Fund's resources.

(iv) If the Fund is to supply currencies on demand its resources must be increased. This can be done either by revising the quotas of member nations and requiring from them thereby a further contribution in gold and currencies, or by the Fund entering into negotiations with members whose currencies are scarce in the Fund, to borrow their currencies and re-lend them to deficit countries.¹ Since the potential scarce currency is the dollar both methods must be judged by their acceptability to the United States. Either a new dollar appropriation for an additional subscription or a loan agreement with the Fund would require Congressional sanction and it would be wise to adopt whichever method is likely in the time and circumstances to secure that sanction.²

The present Fund Agreement demands that in any yearly period the currency buying rights of a member country shall be limited to 25 per cent of its quota³ — thus ensuring that the member shall not exhaust its drawing rights in less than four years. This rule limits the use of the Fund. It might especially do so where recession in one country caused deficits in the balances of payments of other countries whose drawing rights with the Fund were temporarily exhausted. In such conditions all the resources of the Fund should be capable of being brought to bear to prevent the spread of recession.

¹ The Fund has authority to do this under Article VII, sec. 2 (i).

² Clearly another method of increasing reserves of international liquidity would be to raise the price of gold uniformly in terms of all currencies, as provided for in the Fund Agreement. This would result in all existing gold reserves being re-valued at the new price. Such a step, however, is so directly contrary to the declared policy of the United States Treasury *vis-à-vis* its buying price for gold that it seems of little use to regard it as practicable in the near future.

³ Cf. Article V, sec. 3 (iii).

The 25 per cent rule should be rescinded or be capable of being waived by the Fund quickly and at its discretion.¹ The corollary of such a step would be, however, that the Fund should ensure that with a stream of one-way demands for a scarce currency it does not find itself holding only 'soft' currencies. It was to prevent this condition arising that the repurchase provisions were included in the Fund Agreement.²

(v) The present repurchase provisions are unsatisfactory. Since a member's obligation to repurchase only arises when its reserves increase, the Fund's reimbursement is uncertain as to date and amount and may even be postponed indefinitely, if the specified changes in the member's reserves do not take place. Were the Fund to sell currencies to members on a large scale there is some danger that these provisions would be inadequate. They should therefore be strengthened by the provision in future currency sales for contractual repurchase by the buyer of its currency at a specified date or over a specified period. This would prevent the Fund's resources from becoming frozen and, providing the repayment date was not unreasonably short, should not deter members from coming to the Fund when in real need. The repayment terms should, however, be fixed to suit individual cases and should be capable of being waived at the Fund's discretion if circumstances warrant.

(vi) The Fund should redefine its attitude towards controls over payments, discrimination and restrictive practices. Little except frustration is to be gained by its present policy of trying to herd member nations willy-nilly towards a goal which seems almost as distant as when the Fund was set up. We are perhaps too impressed by the abuses to which exchange control has been subject. The Fund should recognise that import restrictions and even discrimination are now firmly established methods of dealing with balance of payments disequilibria and obtaining relief from dollar scarcity and by attempting, without real authority, to deny these to its members it encourages evasion or even open defiance. Instead some such programme as follows might be attempted: (a) a review of the means whereby the Fund can help convertibility of sterling should be undertaken; (b) a review of existing forms of

¹ There have been already a number of cases in which the Fund has waived this condition.

² Cf. Article V, sec. 7.

exchange controls and restrictive practices should be made with a view to defining those which have widely detrimental effects and subjecting these to international discussion and efforts for their eventual abolition; (c) the drawing up and agreement with members of a 'code of behaviour' in respect of the operation of controls. Such a code might provide in the future an internationally agreed standard of use for controls, similar in principle to that which the Tri-Partite Agreement did for exchange rate manipulation in 1936.¹ In certain circumstances (as for example when a country experiences a sudden sharp decline in the demand for its exports as a result of recession in countries to which it exports) the Fund should allow its members to resort to exchange control measures. It should not prohibit legitimate controls in situations where they are the sole alternative to damaging deflations or useless devaluations. Certain objective criteria should be adopted by the Fund on the satisfaction of which it would grant the necessary permission to impose controls. Such criteria might be (a) the size of reserves held by the applicant judged relative to the fluctuations to which its trade is subject, and (b) the rate of decline of such reserves in any given situation. The Fund should also decide upon the most effective measures of control appropriate to balance of payments correction and inform its members accordingly.²

¹ Prof. R. F. Mikesell has tentatively drawn up such a code. Cf. R. F. Mikesell, *'Foreign Exchange in the Postwar World'*, New York 1954, pp. 475-8.

² One writer suggests that multiple currency rates, properly administered, are preferable to direct import quotas or embargoes. The advantages claimed are: (i) that multiple rates prevent profiteering by those who are fortunate enough to import scarce commodities and that they capture the windfall profit for the state; and (ii) that as soon as the temporary deficit passes the free market premiums would vanish and the controls would be self-liquidating. Their prolonged retention would then be the criterion for other adjustment measures to be taken. Cf. R. Triffin, 'National Central Banking and the International Economy', *Postwar Economic Studies* No. 7, September 1947, Federal Reserve Board.

CHAPTER 8

THE WORLD BANK

'Tis better to have loaned and lost than never to have loaned at all.'

Dutch delegate to American delegate at Bretton Woods

THE International Bank for Reconstruction and Development received less attention in the preliminary meetings and at Bretton Woods than did the Fund. It was to be expected that the creation of an international adjustment mechanism, dealing with such controversial matters as exchange rate policy and access to liquid currency resources, would attract more notice than the creation of an international investment agency seeking international co-operation in long and medium term foreign lending. The Bank's scope was limited. It had no direct authority or influence over members as the Fund was supposed to have. Its function was not to monopolise international investment but merely to encourage it, and make it possible in certain marginal cases. Nevertheless, the Bank's potential contribution to a stable world economy was a very real one. Steadiness in the flow of long-term overseas investment by creditor countries is an essential condition of international stability and, if such investment is to be beneficial, it is best planned through an international organisation. The Bank had, therefore, an important complementary role to play, side by side with the Fund. To the more far-seeing at Bretton Woods it was clear that in the years to come international investment would prove to be of crucial importance. The world economy of the nineteenth century, in which Britain as the great creditor used her export surplus to develop overseas areas and was content to take payment for her loans in a flow of primary products, was gone for ever. The United States was now the creditor and she possessed neither the trade structure to promote widespread foreign lending nor the inclination to undertake it. Most important of all, was she prepared to receive repayment and servicing of her

capital in an increasing and unimpeded flow of American imports? All this was to come. Clearly if international investment was to play the equilibrating role in a dollar world which it had played in a sterling world, the framework through which it could function was a vital part of the new international monetary system.

The institution which was created as the complement of the Fund was less novel in conception than its twin. Its purpose was to facilitate the international investment of capital for productive purposes, by making and guaranteeing loans on long and medium term. Its projected scale of operations and the conditions laid down for it in the Articles of Agreement¹ showed that it was to supplement and not to supersede the ordinary flow of private risk capital. Brought to birth in a war-shattered world its immediate task was to aid in reconstruction by promoting loans for the rebuilding of productive machinery.² From this it was to pass in due time to developing the resources and productive capacity of the world's backward regions. In both periods and both tasks it was to 'order its operations as to promote and maintain equilibrium in the international balance of payments of all member countries'.³

Briefly the institutional model of the Bank was as follows. All members of the Fund were to be members of the Bank and were to subscribe its capital of \$10 bln according to a quota system (in September 1956 there were 60 members). The quotas were in most cases the same for the Bank as for the Fund but some were greater, notably that of the United States which at \$3,175 mln was \$425 mln more than that for the Fund. By 1956, \$9,261.2 mln had been subscribed. Each member's total subscription is in three parts: (i) 2 per cent of the subscription is payable in gold or U.S. dollars and is freely available for lending; (ii) 18 per cent of the subscription is payable in the member's currency and is available for lending only with the member's consent; and (iii) the remaining 80 per cent is not available for lending, is subject to call only when required to meet obligations for loans or guarantees, and is really to act as a contingency reserve with which the Bank may guarantee two sorts of loan. First, loans for approved purposes issued by members

¹ Cf. 'United Nations Monetary and Financial Conference', *Final Act*. Annex B, p. 46.

² In this its task was of course different from that of UNRRA which provided only immediate necessities of life for devastated countries in the days immediately following the military collapse of the enemy.

³ Cf. Opening remarks by Keynes to the Second Commission at the Bretton Woods Conference, July 3, 1944.

through the ordinary investment market where, in the absence of the guarantee, they would not be obtainable or, if so, only on onerous terms. Second, loans placed in the ordinary investment market in the Bank's name and the proceeds subsequently re-lent on agreed terms. Of both these types of loan the proceeds are to be freely expendable in any member country, but they are to be made only for specific and approved projects and are never to be used for general purposes. There was no stipulation in the Agreement as to how the Bank was to allot its resources initially between the competing functions of reconstruction and development and this allocation, which gave rise to some discussion at Bretton Woods, was left to its discretion. The regulations governing the functions of the Bank in respect of loans and guarantees are in accordance with orthodox banking precepts and the total amount of guarantees and loans must never exceed 100 per cent of the unimpaired subscribed capital, reserves and surplus, of the Bank.

The organisation and management of the Bank is similar to that of the Fund, supreme authority being vested in a Board of Governors meeting with relative infrequency while active management and policy-making is placed in the hands of twelve Executive Directors.¹ Voting is *pro rata* with the size of quota, each member having 250 votes plus one additional vote for each share of stock held. In addition the Bank has an Advisory Council of not less than seven persons selected by the Board of Governors and including representatives of banking, commercial, industrial, agricultural and labour interests to advise it on matters of general policy. This Council must meet annually and on such other occasions as the Bank may request. Loan Committees may also be appointed to report on the technical aspects of specific projects.

One dominant principle lay behind the 1944 model of the Bank — that of generalising the risks inherent in international investment. It was obvious that only those countries which were fortunate enough to find themselves with favourable external balances would have loanable funds and that, in the postwar world, such countries would be few and conspicuous among them would be the United States. If left to private enterprise the loans made by surplus countries would be subject to considerable risk, worse, they might

¹ Five Executive Directors were to be appointed, one by each of the five members having the largest number of shares. The remaining seven were to be elected by ballot of all countries other than those appointing a director.

not on this account be made at all. The Bank would provide a means whereby, with the minimum interference with the world capital market, the risks of lending would be borne jointly by all countries who were members of the institution — each country being limited in its liability to the amount of its quota subscription, an amount well within its means. By guaranteeing loans raised from international creditors the Bank would allow these creditors to discharge their investment function, but take from them the unwholesome burden of risk which they would otherwise have to bear. Moreover, as time passed the Bank would accumulate resources from the 1 per cent commission charged on all loans and this, with other free reserves, would carry it far without calling on members' subscriptions to meet its obligations. With care and financial skill in management the Bank would be in a position to operate on an expanding basis. By 'thus separating the carrying of risk from the provision of funds' the Bank had a valuable contribution to make in a world economy requiring an abundant and steady flow of capital.

Apart from the soundness of the principle upon which it was conceived the Bank had the merit of simplicity and the advantage of being able to make an immediate contribution to the work of reconstruction. Its tasks were narrow, precise and obviously necessary and the methods proposed, while not revolutionary, were novel and promising. Its task was in essence infinitely easier than that of the Fund, whose whole work had to be pioneered in one of the most difficult periods the international economy had known and which was to stand more or less aloof for five formative years before assuming monetary leadership of the nations. The Bank was greeted as one of the valuable creations of the Bretton Woods Conference¹ and, while all eyes were turned on its precocious twin, it bent to its work.

On June 25, 1946 the Bank formally began its operations and informed its members that the first 2 per cent of their capital subscriptions payable in gold or United States dollars was due within 60 days and that a series of further calls of subscriptions would take place later in 1946 and in 1947. From the first call of 2 per cent of capital subscriptions the Bank received \$143,786,884.²

¹ One of its notable acclaimers was Prof. J. H. Williams. Cf. *Postwar Monetary Plans*, pp. lxxxiv–v.

² This fell short of the amount due by some \$9.6 mln. This was due to certain authorised deferments by countries which had suffered German occupation.

By October 1946 the Bank had received \$241,996,884 of which \$14,072,259 was in gold.

There was no initial rush for loans. By October 1946 when the Bank held its first Annual Meeting only two requests for loans had been received. Most of the countries which had taken part in the war were in need of immediate relief which was then being provided by stabilisation loans or by UNRRA and had not yet reached a stage of recovery in which elaborate long-term plans could be formulated. Nor were under-developed countries quick to avail themselves of the Bank's facilities. Perhaps the most interesting feature which has emerged from the Bank's experience is the limited capacity which backward countries have for absorbing capital for really productive purposes.

The first three years of the Bank's operations were carried on under difficult conditions and, subject to the framework of its Articles of Agreement, were largely experimental. By 1950, however, it considered that its experiences justified the formulation of more specific operational policies and these were set out in its *Fifth Annual Report*.

The general provisions governing Bank lending had been already laid down in the Articles of Agreement. They required that, except in special circumstances, Bank loans should be for specific projects of reconstruction or development; that the projects selected should be those most useful and urgent for increasing the productive power of members; and that, except in special circumstances, Bank financing should be designed to meet foreign exchange rather than domestic currency outlays. The application of these general directives to particular problems was not always easy and it is worth examining these aspects of lending policy more closely.

The specific project provision has been the subject of criticism, being regarded as a facet of the Bank's excessive control and scrutiny. The Bank defends the rule (a) on the grounds that it is necessary to ensure that loans are used for productive purposes, and (b) that in effect the rule is not so stringent as appears at first sight, the only requirement which the Bank enforces being that, before a loan is granted, there should be agreement both as to the goods and services upon which the loan proceeds are to be spent and on the uses to which those goods and services are to be put. It is certainly arguable that, if the Bank is to allot loans on a priority

basis, it is easier to allot priorities to specific projects rather than for vague general foreign purchasing schemes. The Bank has sought to marry the tasks of deciding priorities and the specific project approach by encouraging members to formulate long-term development programmes in which specific projects may be judged as to priority by relation to the programme as a whole. Moreover, the Bank argues that in discussion with the potential borrower it is often able to suggest improvements, modifications and reductions in the cost of the scheme which afterwards prove beneficial. As a final test it must be admitted that if the Bank insists that agreement must be reached with the borrower as to the purposes of the loan, the cause of international investment and development is likely to be better served than if the loan is granted for unspecified purposes.

Before lending the Bank must decide what projects it will finance. 'To be of maximum effectiveness Bank investment must be devoted to those undertakings which will contribute most to strengthening the economy of the borrowing country.'¹ This the Bank can only do by making an extensive study of the entire economy and investment programme of the prospective borrower. Perhaps, in the course of such an investigation, other more essential tasks will suggest themselves. Even if the Bank undertakes to finance the project suggested this may release resources already available to the borrower for some other activity, on the execution of which the Bank's advice may also be of use. The Bank thus seeks not only to protect its own interests by applying exacting criteria to its support of proposed projects but it aims at inculcating into member nations similar criteria to be applied to the use of their own resources. On the nature of these criteria the Bank is, however, somewhat vague and in fact admits that there is 'no single test by which the relative urgency and productivity of alternative projects can be judged',² but that the situation in each country must be considered — an admission in the face of which its claim to educate the backward in financial probity sounds somewhat lame.³

¹ Cf. *Annual Report for 1949-50*, p. 9.

² Cf. *ibid.*, p. 9.

³ Broadly the process of Bank investigation attendant upon a loan is in three stages. First there are exploratory discussions with prospective borrowers before any formal request is made. This enables the Bank to decide whether the project is of a type which it can consider and to inform the applicant of what information it will require before a decision can be reached. Once formal application is made

The Bank believes that the borrowing country should hold some financial stake in the project and for this reason it is the general policy of the Bank not to finance the entire cost. The Bank regards the foreign exchange expenditure which may be incurred in the execution of a project as being of two types: the foreign exchange cost of importing goods (or services) directly needed for the project; and the foreign exchange cost of any additional demand for imports which may be generated by the rise in home incomes resulting from the investment. These latter are referred to as 'local currency expenditures' — a somewhat misleading term. Although the Articles allow the Bank in 'exceptional circumstances' to make loans in respect of local currency expenditures the practice has been to grant such loans only in rare cases, the justification for which has been that if the additional imports did not take place the country would suffer inflation in its economy. For its frequent refusal to grant local currency expenditure loans the Bank has been adversely criticised, but it is hard to see how it could make such loans often, since they must necessarily be of a general character and are more properly stabilisation loans than loans for reconstruction.

In settling its loan charges the Bank aims at 'the lowest rates that it considers consistent with reasonable prudence to safeguard those who supply its funds and those who guarantee their repayment. It is also the Bank's policy to make no distinction among its members in determining the charges on loans.'¹ The loan charges are compounded of two elements, interest and commission. The main determinant of the interest rate is the rate at which the Bank can itself borrow in the market for a similar period. The lending

the actual process of investigation begins. There is a general examination of the economy of the would-be borrower with a view to determining (a) the amount of additional external debt which the borrowing country can safely shoulder, (b) the order of priority of projects under consideration relative to the country's economic development, and (c) the appropriateness of government economic policy to the development schemes. Such a general survey necessarily takes time but once undertaken the data acquired can be supplemented from time to time and in the case of subsequent loan requests this preliminary survey will be unnecessary. The Bank next despatches a mission to study conditions on the spot and from the mission's report it forms a provisional judgement upon the worth of the project and its contribution to the economy of the borrower. If it is thus far satisfied the Bank next proceeds to a detailed examination of the project, both as to its technical and financial aspects. Once this is satisfactorily completed the Bank informs the applicant that it is prepared to enter into negotiations for a loan. The formal negotiations are usually brief.

¹ Cf. *Annual Report for 1949-50*, p. 13.

rate is then calculated to be marginally greater than its own borrowing rate, the margin to be such as to cover operating expenses and the making of suitable allocations to reserves.¹ The commission, the proceeds of which are allocated to a special reserve to meet Bank liabilities on borrowing and guarantees, is regulated by the Articles of Agreement to be from 1 to 1½ per cent and at present (late 1956) a uniform commission of 1 per cent per annum is charged on the outstanding amounts of all loans.

The Bank's relations with a borrower continue even after the loan is made. In particular it checks and scrutinises the expenditure of loan funds, seeing that they are used to purchase only authorised goods appropriate to the project which is the subject of the loan agreement and checking the uses to which such goods are put. In a more general way the Bank keeps itself informed of economic and financial trends in the borrowing country and insists upon very close liaison with the borrower. Its claim is that only in this way can it 'ensure that the maintenance of service on Bank loans is not jeopardised by the emergence of conditions which might reasonably be prevented'.² The Bank also claims that during its loan operations it can give technical aid to its member countries, as for example advice on technical problems, on marketing or managerial problems, and by assisting with the financial aspects of undertakings. In adjudicating on a wide range of problems, technical and economic, the Bank requires much more knowledge and advice than its own staff can supply and it has built up a worldwide system of consultation with experts in many countries and sought the aid of many organisations, international, national and private. This function of rendering technical advice has on occasions been broadened when countries have asked the Bank to organise a complete survey of their economies. These have involved the sending of an international mission to the country concerned to study and report on such aspects of its economy as investment policy, productive efficiency, and governmental policies.³ Such surveys are not directly concerned with the Bank's financial operations but it argues that, as an international institu-

¹ The full interest charge is only made on that part of a loan which is actually disbursed. On the undisbursed part a commitment charge is levied, this being calculated to compensate the Bank, in part, for the cost of holding funds at the borrower's disposal.

² Cf. *Annual Report for 1949-50*, p. 17.

³ Among countries requesting such surveys have been Columbia, Turkey, Guatemala, and Cuba.

tion, it is bound to carry them out and that, in the long run, it is in its interests to do so.

In accordance with these operational policies the Bank's work has proceeded. It is refreshing, after the stereotyped and inflexible Fund, to turn to its fellow which, from the outset, regarded its constitution and articles with respect rather than awe, but allowed its working practices to be distilled from experience. Whatever criticisms might be levelled at these practices (and they are not without blemish)¹ it must surely be admitted that this was the correct and more practical approach.

It remains to touch briefly upon the main aspects of the Bank's work to date. These can be treated as (a) its operational activities and (b) its financial transactions.

(a) Between 1947, when the first loan was granted to France, and June 1956, 150 direct loans were made by the Bank amounting to \$2,667 mln.² Of this amount \$497 mln were for what the Bank describes as 'reconstruction loans' while the remaining \$2,173 mln can be summarised as being in respect of projects in the fields of electric power, transportation, communications, agriculture and forestry, industry and general development. Of the total value of loans made 36 per cent have gone to Europe, 24 per cent to the Western Hemisphere, 16 per cent to Asia, 13 per cent to Africa and 11 per cent to Australasia. Table VI shows the sources from which the Bank has lent and the disbursements to date. It will be observed that the Bank's funds available for lending come from three main sources: the initial payment of 2 per cent of members' subscriptions; such part of the further payments of 18 per cent of subscriptions as members may authorise the Bank to lend; and the Bank's own issue of bonds. The use of so called '18 per cent funds' by the Bank is subject to the permission of the member whose currency is to be lent. Such permission was granted by the United States from the outset, and since loans were for the purchase of capital equipment which was, at that time, available only

¹ It is impossible to embark upon a full scale criticism of these operational policies. Briefly, it can be claimed that they erred on the side of excessive caution and allowed far too little initiative on the part of the borrower. The exhaustive enquiries upon which the Bank insisted also retarded the rate of its lending. This will tend to quicken with the Bank's growing knowledge. The Bank for its part claims that any increase in the pace of lending would have been at the expense of the productiveness of the loans made. Perhaps indeed it was wise in its formative years to err on the side of caution.

² This figure is net of cancellations and refunding of \$52 mln.

in the dollar area, tardiness on the part of European members in granting permission to lend their currencies was of little importance. Later, however, as the supply position in Western Europe improved the Bank's borrowers were attracted to buy in European markets¹ and the Bank has been pressing its European members to release their 18 per cent subscriptions. Up to June 30, 1956 \$256 mln had been made freely available by Western European members, while a larger sum was available for lending in certain circumstances, subject to consultation and limitations. By 1954 almost all the 18 per cent funds were conditionally available and during the years 1953-55 there was a considerable increase in the

TABLE VI

*Bank's Available Funds and Loan Disbursements
to June 30, 1956
(U.S. dollar equivalent)*

	(\$ mln)
2% portion of subscription of all members - - - -	178.4
18% portion of subscription so far made available - -	893.1
Total available from capital subscriptions - -	1,071.5
Funds available from operations - - - - -	159.5
Funds available from sale of bonds - - - - -	850.2
Funds available from principal repayments and loans sold or agreed to be sold - - - - -	433.9
Gross total available funds - - - - -	2,515.1
Loan disbursements - - - - -	1,963.7
Balance - - - - -	551.4

Source: Annual Report of IBRD for 1955-56

growth of funds available from non-United States sources — part of this increase coming from the release of 18 per cent capital subscriptions, part from payments of interest and loan charges and part from bond sales. Nevertheless, the conditions imposed by European members upon the use of 18 per cent funds seriously

¹ The geographical distribution of loan expenditure cumulative to June 30, 1956 was: United States 61.7 per cent; Europe 28.1 per cent; elsewhere 10.2 per cent.

curtailed their use by the Bank, and by June 1956 the Bank had used or set aside for use only 44 per cent of the 18 per cent subscriptions of European members.

The Bank's reconstruction loans were all made in 1947,¹ and were, contrary to the Bank's designed practice, general purpose loans,² aimed at alleviating the balance of payments difficulties of the countries concerned. It was felt that Europe's difficulties following the war were so extreme that relaxation of the 'specific project rule' was justified and that, since the Fund was husbanding its all too meagre resources, the Bank would have to supplement them. In the spring of 1948 came the announcement of the Marshall Plan and in its *Third Annual Report* the Bank announced that 'until the form and content of the European Recovery Programme had taken shape the Bank could make no large loans to Europe'.³ Thus it acknowledged, as did also the Fund, that Marshall Aid was to serve Europe's needs and that the Bank could concentrate its efforts elsewhere. Nevertheless, some small loans were made in 1948 and 1949, mainly to the Netherlands for industrial modernisation and the purchase of ships and to Belgium for the construction and equipment of steel mills in the Liège area.

Development loans began in 1948 with two loans to Chile for hydro-electric power development. Thereafter the Bank's resources were devoted mainly to non-European countries — although some loans were granted to European dependencies in which the mother country acted as guarantor.⁴ The terms of development loans have differed. Dates of maturity have been from seven to thirty years, varying with the nature of the project. Rates of interest ranged from 3 to 3½ per cent for short-dated loans to 5

¹ To France \$250 mln; to the Netherlands \$195 mln; to Denmark \$40 mln; to Luxembourg \$12 mln.

² Article 3, sec. 4 (7) of the Bank Agreement states that 'Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development.' The insertion at Bretton Woods of the saving clause 'except in special circumstances' enabled these general loans to be made for the purchase by the borrower of a wide range of industrial, agricultural and transport equipment required for the rehabilitation of its economy. Since such equipment had all to be imported these loans were in the nature of balance of payments adjustment loans and supplemented the activities of the Fund whose articles precluded lending to members for reconstruction purposes.

³ Cf. *Third Annual Report for 1947-48*, p. 8.

⁴ Notably \$40 mln to the Belgian Congo in respect of a ten year development plan and loans totalling \$42 mln to the Rhodesias for railway and electric power development.

per cent on certain long maturities.¹ While not unduly high, such rates have proved a deterrent to some marginal borrowers. European countries in particular preferred to obtain credit through ERP loans which were on more favourable terms.

Two criticisms have been made of the Bank's loan policy: the limiting effect of insisting on specific project loans, and the degree and method of control exercised by the Bank over such projects. In the immediate postwar period there was reason for both precautions, particularly in the case of weaker borrowers and to ensure that the Bank's operations remained distinct from the Fund, but there is now some case for relaxation of these disciplines. There is little doubt that the Bank's close scrutiny of expenditures and detailed control of the uses to which its loans are put has deterred some potential borrowers. The conditions of disbursement² demand that 'the proceeds of the loan are subject to withdrawal by the borrower only upon satisfactory certification that expenditures have been made or will be made for the purchase of authorised goods and services, that the cost and terms of purchase thereof are reasonable and that the cost has not been and will not be financed out of any other credit available to the borrower. The borrower must also submit to the Bank in due course documentary evidence of the purchase, payment and delivery.' Such control as this may be justifiable in dealing with weaker borrowers but it must be regarded as unduly restrictive by borrowers who have technical and financial talent at their command. It is the less tolerable in that all loans, other than those direct to governments, are guaranteed by a government, central bank or other institution approved by the Bank. The drawbacks of such detailed control were too much for the Colonial Development Corporation who broke off negotiations for a loan from the Bank, saying that, despite its ability to give security such as would satisfy normal banking requirements, the Bank had insisted on applying its usual formula. It seems essential that the Bank should evolve a formula which reduces supervision to a level compatible with safety in lending. One method of approach would be for the Bank to lend to some financial agency of standing in the borrowing country on the understanding that the agency would relend for development within the country. The Bank has already made loans

¹ These rates include the Bank's flat rate commission of 1 per cent.

² Cf. *Annual Report for 1947-48*.

of this type. On July 29, 1949 the Bank made a loan of \$15 mln to the Netherlands Finance Corporation for National Reconstruction (Herstelbank) guaranteed by the Netherlands Government. The Herstelbank was in turn to make the proceeds of the loan available to 24 Dutch corporations in various industries to finance part of their requirements for imports of equipment from hard currency areas required for reconstruction or modernisation of plant. Again in October 1950 a loan of \$10 mln was made available to small enterprises in Mexico through a loan made to a group of eight of the principal Mexican banks and the official financing agency of the government. Along such lines useful progress might be made.

(b) In early 1947 the Bank turned its attention to supplementing its lendable resources by borrowing in the capital market and, since such borrowing would initially have to be done in the United States, a nation-wide publicity campaign was undertaken in that country to inform potential lenders of the Bank's activities, financial soundness and prospects. Legislation was sought in individual states of the Union to allow institutions such as insurance companies, commercial banks and savings banks to invest in Bank securities. As a result by the end of 1949 the Bank's bonds were legally established as a recognised investment for institutional investors in over 40 states and Congressional authorisation had been obtained for national banks in the United States to deal in Bank bonds and for the Bank to sell its bonds (or bonds guaranteed by it) without registration with the United States Securities and Exchange Commission.

On July 15, 1947 the Bank made its first public issue consisting of \$100 mln 2½ per cent Bonds redeemable on July 15, 1957 and \$150 mln 3 per cent Bonds redeemable on July 15, 1972, both at par. The issue was over-subscribed and the Bonds soon went at premium prices. In the following year the Dutch shipping loan gave an opportunity for a different type of borrowing. On August 6, 1948 the Bank sold with its guarantee to a group of ten United States banks \$8.1 mln of the notes received from the Dutch shipping companies in respect of this loan. The balance of the Dutch notes (\$3.9 mln) was retained by the Bank. In 1948 also the Bank borrowed for the first time outside the United States when it made an issue of 2½ per cent Swiss Franc Serial Bonds to an amount of 17 mln francs (about \$4 mln). This entire issue was

purchased by the Bank for International Settlements (at par) and immediately lent to the Dutch Government as a loan supplemental to the shipping loan referred to above.

No new issues were made during 1949. The market for bonds in the United States was unfavourable and the demand for currencies other than the dollar was not sufficient to warrant issues in other countries. The Bank persisted, however, in its policy of selling to private investors, with its guarantee, notes received by it in respect of loans. By the autumn of 1949 \$28 mln had been thus transferred from the Bank's loan portfolio to private investment accounts.

In January 1950 the Bank redeemed a former issue by a successful public offer in the United States market of \$100 mln 2 per cent Serial Bonds of 1950 (redeemable 1953-62). The issue was sold by competitive bidding to underwriters and as a result the average net interest cost of the issue to the Bank was 1.93 per cent per annum — a worthwhile saving in its borrowing cost. On March 1, 1950 the Bank again raised funds in Switzerland by selling to a Swiss bank group and to the BIS 28.5 mln Swiss francs worth of 2½ per cent Swiss Franc Serial Bonds — the equivalent of about \$6.6 mln.

In 1951 the Bank for the first time made an issue in London when it sold £5 mln 3½ per cent Stock 1966-71 to a London banking group, the securities being later offered on the London market and receiving a favourable reception. By 1951 the market for the Bank's paper had greatly widened and some \$60 mln of its direct and guaranteed indebtedness was held outside the United States.

Between 1951 and the present (1956) the Bank's loan disbursements increased sharply and, with this, its necessity to borrow. By June 30, 1956 bonds equivalent to \$850 mln were outstanding of which about 56 per cent was held in the United States — mainly by institutional investors. The year June 1953-June 1954 saw the peak of the Bank's borrowing when five new bond issues totalling \$221 mln were offered and subscribed. The four issues made in the year June 1954-June 1955 were all sold outside the United States — an interesting proof of the growing international market for Bank securities.

The Bank's borrowing has so far been successful but it is noticeable that it has been on a cautious scale, that it has borrowed

only where and when the success of a loan was certain, and that the scale of its lending has allowed its procurement of funds from this source to be unhurried. If, however, the increase in the volume of lending which has characterised the last three years is continued it may be driven to seek resources on a much more ambitious scale. It will be seen from Table VI that funds for future lending must come from two sources: from new releases by members of '18 per cent' money; and from borrowing. The rate at which further unconditional releases of '18 per cent' money may be expected is problematic since it depends predominantly on the balance of payments position of the members concerned, and the value of the release is determined by the extent to which the released currency is convertible. Although the Bank is exerting pressure on members to make liberal releases the response is not encouraging, and it is probable that the Bank will have to draw much of its loanable resources in the future from the proceeds of its own issues.

The record of the Bank is one of quiet success. It has contributed modestly to the flow of international investment since the war and the volume of its transactions is increasing. Its loans, totalling \$2,720 mln, have made a contribution towards alleviating the dollar shortage, and have enabled a considerable number of projects in small and backward countries to be undertaken which, because they are only indirectly productive or profitable, would not have been undertaken without the Bank's aid. It has become a specialised institution to deal with such projects and its usefulness cannot be judged solely by the statistical record of its loan operations. A notable feature of the Bank is that it has gained the respect and confidence of business and financial interests, being itself run as a business by bankers in close collaboration with Wall Street and financial interests throughout the world.

In 1955 a proposal was made by the United Nations for expanding the basis of international investment: that a subsidiary organisation should be set up to work with the Bank and perform tasks which fall outside the Bank's terms of reference. This organisation, to be known as the International Finance Corporation will seek to encourage the growth of productive private enterprise in under-developed areas. In association with private investors and without any government guarantee it will invest in new undertakings. It will have more latitude than the Bank and its principal task will be the supply of risk capital for industry. The Corporation will have

an authorised capital of \$100 mln of which the United States will subscribe \$35 mln and the United Kingdom \$14.4 mln — all subscriptions to be in gold or dollars. The Articles of Agreement of the Corporation¹ came into force on July 20, 1956 and the inaugural meeting was held on July 24, 1956.

It is not our task here to adjudicate upon the Bank's actions and policies in the field of economic development. These are important; in the last resort they are the most important of its functions. Our concern is with monetary co-operation and we must judge the Bank by the contribution it has made to world payments equilibrium by promoting investment. In this field its scope is restricted by the resources at its disposal and by the fact that it was designed to supplement the normal processes of private international investment and not to replace them. Only a vast flow of international investment by the United States would serve to offset the great favourable balance of her current account and it is clear that nothing like the necessary amount of capital export is likely to be forthcoming. That is not the fault of the Bank, which, like the Fund, was designed to function in a world in which equilibrium had been restored and was subject only to transient interruptions.

Its lot has been cast in a world where international payments have been and are disrupted by structural imbalance. Even in such conditions and within its limitations its contribution has been considerable. It has shown that international functional co-operation has meaning and reality. It may yet have greater and more extensive work to do.

¹ Cf. *International Finance Corporation. Articles of Agreement and Explanatory Memorandum*, London, HMSO, Cmd. 9502 of 1956.

CHAPTER 9

REGIONAL CLEARING SYSTEMS: THE STERLING AREA

I

PAYMENTS between nations may range from the bilateral settlement of balances where currencies are inconvertible and cannot be exchanged for other currencies save with official sanction and for specific purposes, to a fully multilateral system under which any currency may be exchanged for any other in exchange markets, and a balance earned in one country used to settle debts in any other. Throughout the nineteenth century and to 1931 the settlement of international payments was multilateral. Currencies, being convertible into gold at fixed parities, were freely transferable through the exchange markets while gold itself acted as a universal means of settlement. Moreover, sterling acted as an international currency. Freely convertible into gold, it was the international unit of account, and sterling bills on London financed much of the world's trade. Since most internationally traded goods were invoiced in sterling, foreigners found it convenient to hold balances in London banks.

In 1931 the gold standard system came to an end and the international economy divided into several loosely knit groups. True, the multilateral settlement of indebtedness endured over much of the world until the Second World War in 1939 but, in the years 1931 to 1939, it became increasingly clear that the old system was breaking down and that multilateralism had died with the gold standard. Four groups emerged. The countries of central and eastern Europe — notably Germany and Czechoslovakia — made immediate use of exchange controls and pursued expansionary domestic policies, adjusting their external accounts by direct controls and conducting their trade on a bilateral basis. A number of countries — France, Italy, Belgium, Switzerland and Holland — remained on the gold standard until 1936 and comprised the so-

called Gold Bloc. Then also was born the First Sterling Area in those countries who followed Britain off the gold standard and, because it served their interests or because as members of the British Commonwealth they had little choice, linked their currencies with sterling and held their currency reserves in London. Finally, there was the United States (joined by Canada who was fearful that sterling might diverge too much from the dollar), also abandoning the gold standard in 1933 and at grips with her massive unemployment problem; already a world creditor and, by her wealth, skill, and productive power, destined to become increasingly so; indifferent herself to external trade, but already having great influence over the external trade of other nations. Such was the grouping in 1931. In the years which followed it was to develop and from the melting-pot of World War II to emerge somewhat transformed yet still recognisable.

The Sterling Area by 1945 had become part of the British war machine. Consisting only of the British Empire (plus Eire and minus Canada), its aim could be summed up as discrimination in the interests of conservation. Behind the high fence of exchange control sterling was the medium of payment in an area containing a quarter of the world's population and carrying on a quarter of the world's international trade. The Sterling Area constituted in fact a great multilateral trading area on the basis of sterling.

In Europe the war had wrought devastating changes. The countries of Eastern Europe, which fell under Soviet influence, withdrew from the trade of Europe. In Western Europe the shortage of necessities and the overpowering need for physical reconstruction and investment in productive and social capital, gave rise to an insatiable demand for goods, some obtainable in Europe but many only obtainable in the United States. All countries faced, in varying degree, a double exchange problem; they could not immediately export sufficient to pay for the imports which they needed, nor could they use their export earnings in one country to buy in another. These problems invoked new experiments in international co-operation. A series of payments agreements, linked with American aid, freed Western European trade from the strait-jacket of bilateralism and led, under American influence, to a system of regional multilateral clearing in the European Payments Union, while under the aegis of OEEC, wider aims of European economic integration and trade liberation were pursued. Britain,

the centre of the Sterling Area system, became a member of the OEEC and the EPU, thus establishing a bridge between the two great regional groups of Western Europe and the Sterling Area.

Finally, the United States and Canada stood aloof from both these groups, their external balances overwhelmingly favourable, their currencies convertible, universally acceptable, and strongly in demand.

The division of the world economy into regional groups, in each of which there is multilateral trade but between which trade and payments are restricted, still persists. The plans made at Bretton Woods assumed that, after a transition period, multilateral trade would be restored and, with the Fund as the arbiter of international payments, the ITO as the arbiter of trade, and the Bank as an aid to international capital flow and economic development, the world economy would be capable of operating smoothly. So far we have been concerned in this study with the institutions which were based on this hypothesis; we must now turn to the consideration of institutions which have been shaped by events themselves and which have been created by the impelling force of immediate necessity rather than by elaborate planning. Within this regional set-up there have been co-operative efforts from which much may be learnt. We will examine these in turn: first the role played by the Sterling Area in the present world payments system, and then the painstaking efforts to rebuild Western Europe's payments system.

II

The Sterling Area is typically British. It has no written constitution; no formal machinery of government or consultation. It was never consciously constructed (at least until 1939) and it has grown, like so many British institutions, to the dictates of experience and sheer utility. This has given to the system a flexibility which has served it well, enabling it to adapt itself to changing circumstances. We are compelled to examine the Sterling Area in some detail for two reasons: first, it has been one of the most successful voluntary organisations for mutual monetary advantage ever evolved; and second, without an understanding of its organisation it is impossible to understand fully a number of problems which we must deal with in later chapters.

In its evolution the Area has passed through four distinct phases. First, there was the half century before 1931 during which

sterling was a worldwide currency, used because of its efficacy as a means of international payments and as a vehicle for the holding of liquid reserves. This 'sterling world' cannot in any formal sense be related to the Sterling Area as we know it today, but the modern grouping could hardly have developed had it not been for the institutions which were then established and the methods of co-operation which grew up between the City of London and the main trading countries of the world. The ramifications of British banking and finance were worldwide. Not only did British commercial banks establish branches abroad but many overseas banks were started with London capital. It became common for such banks to hold part of their reserves on deposit in London and when, in the nineteen-twenties, dominion central banks were established they too adopted this practice, thus making London the holder of the monetary reserves of many countries. Throughout the later nineteenth century the countries of what is now the Sterling Area used sterling as an international unit of account, converting such part of their foreign earnings as came to them in other currencies into sterling and adding this to their London balances. When payments were to be made in gold or foreign currencies a draft on a London sterling balance was sufficient, for sterling could be converted into gold or into any currency on demand. This international unity under sterling survived the period 1914-25 during which sterling was not convertible into gold, partly because this condition was widely regarded as a temporary wartime interlude and partly because this was the period when foreign central banks took to keeping a part of their monetary reserve on deposit in London.¹

When, in 1931, Britain cut the link between the pound and gold and allowed her currency to depreciate, the unity of the international economy was broken. Countries associated with the United Kingdom had then to decide whether to remain on the gold standard, to quit the standard and allow their currencies to depreciate with sterling, or to quit the standard and manage their currencies independently. A number of countries chose the second alternative and, nervous of fluctuating exchange rates, decided to stabilise the rate between their own currencies and sterling. Thus was born the Sterling Area — or as it was then called the Sterling

¹ For a good description of the nineteenth-century role of sterling see Brian Tew, 'Sterling as an International Currency', *Economic Record*, June 1948.

Bloc. By 1933 it consisted of the British Commonwealth (except Canada and Newfoundland), the Colonial Empire and Mandates, Eire, Egypt, Iraq, India, Iran, Siam, Portugal, Sweden, Norway, Denmark, Finland, Esthonia, and Latvia. Various motives influenced the decision of these countries to join. Some had little choice. The political solidarity of the Empire demanded that they should follow sterling. The close financial relationship of the colonies and dependencies with the United Kingdom demanded that a parity should be maintained with sterling. Many, for example, owed long-term debts which were payable in that currency. Then again, it was bruited abroad that the new Sterling Bloc might be the basis of a new British commercial policy and that countries dependent upon sales in the British market would do well to put their names up for immediate membership.¹ Finally, a number of late-comers may have been induced to join because of the fact that Britain did not suffer in the great recession of 1929-32 quite so severely as some of the other great economies, because the value of sterling in terms of commodities remained relatively stable, and because it became increasingly clear that those countries remaining on the gold standard had currencies which were seriously overvalued. The loose company of nations which comprised the Bloc was as varied as the above motives suggest but the main link which bound them was that all believed that it served their interests best to keep the external values of their currencies in a fixed relationship with sterling. There was no group organisation and no articles of agreement. Members of the Bloc did not ask Britain's permission to adopt sterling as their standard nor did they ask it if they left the group. Countries came and went at will.

While within the Bloc, member countries could devalue or appreciate their currencies relative to sterling just as under a gold standard they could have changed their currency's value relative to gold. The pound was still fully convertible into gold, not at a fixed price, but at the price at which gold changed hands in the bullion market. Exchange rates within the Bloc were stabilised, members quoting an official exchange rate with sterling, but between sterling and non-sterling bloc currencies they fluctuated widely, particularly before the conclusion of the Tripartite Agreement in 1936. Indeed, conditions within the Sterling Bloc were in principle similar to those of the gold exchange standard save that

¹ A view which was of course justified by the Ottawa Agreements.

the medium of international settlement was the pound and the standard a sterling standard. For all member countries held their reserves in sterling and not in gold,¹ their central banks bought and sold sterling at the official rate and external deficits with other members were settled by sterling transfers. The assumption was implicit that members would prevent an undue depletion or accretion of their reserves by varying the parity of their currencies with sterling, but in fact this was rarely if ever resorted to.

The Sterling Bloc was little more than an international club of nations pursuing similar monetary policies and bound by similar interests. So long as the pound remained convertible into other currencies the Bloc was neutral so far as its effects upon other countries were concerned. It was in fact no more than a fixed exchange rate area justified by convenience.

Even outside the Sterling Bloc many central banks maintained the practice, which had obtained under the gold standard, of keeping a large part, or even all, of their working balances in sterling. Sterling remained much the most widely used medium of international payments and, indeed, up to 1939 it lost little of its status as an international currency. It still retained even after 1931, the essential attributes of such a currency — stability in value and wide acceptability as a means of payment. Although it had depreciated by about 40 per cent relative to the Gold Bloc currencies in the three years after 1931 it had held its value relative to the currencies which had followed it, and formed a stable unit for the holding of their reserves. Moreover, in these years of fluctuating exchange rates Britain had devised in the Exchange Equalisation Account a means of minimising short period fluctuations in sterling exchange rates. Finally, judged by acceptability, sterling remained as a result of the widespread Sterling Bloc a useful means of international settlement.

The outbreak of war in 1939 demanded greater cohesion and organisation within the Area, and its character changed. As war approached non-Commonwealth countries stopped linking their currencies to sterling and curtailed their sterling balances in London. The Area's membership shrank till it consisted only of the British Commonwealth (except Canada) Eire, Egypt, the Sudan, Iraq and Iceland. Most important, however, its main aim now became that of conserving 'for essential uses both the stocks and the

¹ South Africa was an exception. She kept her official reserves mainly in gold.

current earnings of the currencies of certain countries and of the gold which could purchase them.¹

To this end there was instituted in 1939 a system of exchange control which has remained in force ever since and has been the main formal link binding the group. The control operates on the principle that it should regulate payments into and out of the Area as a whole, and allow payments between countries within the group to remain free. This required the pooling of the hard currency resources of the group, and, in return for assurances that their needs would be met, the central banks of the countries of the Overseas Sterling Area sold agreed percentages of their hard currency earnings to the Bank of England. Into this pool were fed the dollar proceeds of the Sterling Area — predominantly the proceeds of the primary commodity sales of the overseas members. Newly mined gold also came to the pool from South Africa, Australia and other sources. Although the main responsibility for operating the control has rested upon London there is an element of decentralisation in that the Dominions have autonomy and may authorise the transfer of sterling either to a country in the Sterling Area or to a country outside it, and may have access to the Area's central reserve pool for converting sterling into gold or dollars.² Co-ordination of the control was obtained by utilising currency boards already established in the Colonies and through the Dominion central banks.

The establishment of exchange control in 1939 was a violent break with tradition for a country which had gained its financial leadership by complete freedom of movement of funds and gold. Yet, once taken, this step was a turning point for the Sterling Area. Within its ring of controls it was possible to maintain a great free payments area both during and after the war. Had this system disintegrated much would have been lost and its preservation has given order and system to what might otherwise have been financial

¹ Cf. Sir Dennis Robertson, *Britain in the World Economy*, London 1954, chap. 2, 'The Sterling Area', p. 36.

² Changes have been made from time to time in the pooling arrangements. The most important have been: (i) the withdrawal of South Africa from the dollar pool as from January 1, 1948; (ii) the postwar introduction of fixed quotas of hard currencies for certain countries, notably India, Pakistan, Ceylon and Eire; (iii) the granting by the United Kingdom in 1949 to Ceylon of a separate gold and dollar allotment from the central pool. The fixed quotas for hard currencies were subsequently withdrawn and by 1951 access to the pool was governed only by a gentlemen's agreement.

anarchy. Moreover, the present machinery of Sterling Area payments ensures that, when conditions justify the step, the pound can again be made convertible into dollars thus linking the Sterling and Dollar Areas in a worldwide system of free and multilateral payments. In order that the exact nature of this decision may be understood it is necessary to consider the evolution and present nature of the Sterling Area payments system.

The exchange control of September 1939 was governed by the Defence Regulations. Later as conditions changed, the system became more elaborate and it was given precise formulation in the Exchange Control Act 1947. From the outset it was decided that, for purposes of control, the Sterling Area should be treated as one single unit within which there should be the maximum free movement of Funds and the general principle has been adhered to that within the Area payments for current and capital transactions are free of control. All of the so-called Scheduled Territories of the Sterling Area maintain their own national systems of exchange control, thus forming a system in which sterling may circulate as a free currency.

Powers of control are vested in the Treasury for which the Bank of England acts as agent. In turn the Bank of England gives powers to the commercial banks, issuing instructions in the form of Exchange Control Notices to bankers. Powers are also delegated to stock exchanges, registrars, travel agents and others — the object being to decentralise administration as much as possible.

The principle underlying the system is simple. All gold and foreign currency earned is directed into a single pool, the Exchange Equalisation Account, and all external payments are made from that pool. All residents of the United Kingdom are required to sell to an authorised dealer for sterling at the official Bank of England price or rate of exchange all foreign currencies which they acquire.¹ Gold has also to be surrendered.² Moreover, exporters are permitted to accept payment only in currencies prescribed for exports to each country, in sterling or in certain specified currencies. The authorised dealers must surrender the gold and foreign exchange which they collect to the Bank of England who hold it in the Ex-

¹ An exception was made in December 1950 when exporters to the Scandinavian countries were allowed to retain their earnings of the three currencies. This arrangement lapsed in March 1954.

² Except by gold dealers and manufacturing jewellers operating under licence.

change Equalisation Account.¹ In this way all the essential means of payment which the country acquires are centralised in the Exchange Equalisation Account.

Elaborate arrangements exist to ensure that the proceeds of export transactions are received in full, without delay and in the right currency. For each export shipment there is a form in duplicate, one part of which is retained by the Customs (who check that the goods are correctly described and valued) and the other part by the exporter who must receive payment within six months unless he has the Bank of England's approval to extend longer credit. When payment is made the exporter hands his part of the form, together with the relevant invoices, to his bank who send it to the Bank of England, who, in turn, check it and forward it to the Customs to complete the check. By this means there is control of the means of payment, the period of credit, the valuation of the shipment and the surrender of the foreign currency proceeds.

Control over the receipts of foreign currency in respect of such remittances as freight, insurance premiums, fees, royalties, etc., depends upon the legal liability of recipients to surrender these. There is also control of the disposal by British residents of shares in foreign firms or foreign securities.

So far as the use of foreign exchange is concerned Part II of the Exchange Control Act prohibits any unauthorised call upon the exchange reserves of the United Kingdom, and permission must be obtained for all payments to persons outside the Scheduled Territories and applications to make payments in foreign currencies must be made through a bank and approved by the Bank of England. Not until the sterling transfer form has been approved by the latter can the debtor's bank make the payment. The authorised banks have, however, a measure of autonomy in approving payments. All payments for imports, for example, may be approved

¹ Only the authorised dealers can buy and sell foreign currencies for sterling and only they can buy gold and currencies from the Exchange Equalisation Account. Up to December 1951 the Account bought and sold the specified currencies from the dealers at almost equal buying and selling prices. Since that date, however, the Account has widened the spread between buying and selling prices and permitted the authorised dealers to deal in foreign currencies and in gold themselves. Prior to December 1951 the buying and selling rates of the Account for the United States dollar were $\$2.80\frac{1}{2} = \pounds 1$ and $\$2.79\frac{3}{4} = \pounds 1$ respectively; after that date they became $\$2.82$ and $\$2.78$ respectively. Subsequently the sterling-dollar rate at which dealers bought and sold, either with one another or with the public, fluctuated between these limits.

by them providing the importer has obtained the appropriate import licence from the Board of Trade. The Customs are then responsible for certifying that the goods are in fact imported and are of the type, quantity and value specified. A number of other types of payments abroad may be approved by the authorised banks, notably commercial liabilities of a contractual nature — fees, freights, interest and redemption payments for sterling securities, ships' expenses, canal dues and the like — all of which must be paid as quickly as possible if commercial efficiency is to be preserved — and foreign exchange required for travel, over and above the normal tourist allowance. The treatment of all such applications has already been highly formalised, but for a third group of applications, those which must be judged on individual merit, the approval of the Bank of England must be obtained.¹ In addition to the current payments there are numerous and various requests for import and export of capital. From a balance of payments viewpoint these are of equal importance with current transactions, but they are more difficult to adjudicate upon and are less amenable to formalised routine treatment. In its administration of the whole system the British Treasury seeks to obtain two objectives: to facilitate normal current transactions as much as possible; and to keep the strictest surveillance and control of capital transfers.

In planning the sterling payments system it was decided that the Sterling Area should be treated as one single unit within which there should be the maximum free movement of funds.² All neutrals were to be treated as one category between which and sterling there was to be no automatic convertibility. From July 1940 the sterling accounts of the United States and of Switzerland were given special treatment. The United States would, at that time, only supply munitions on a 'cash and carry' basis and all sterling accounts of the United States (and Swiss) banks were to be treated as 'Registered Accounts' and all payments between the Sterling Area and the United States were to be made either in dollars or in convertible sterling through a Registered Account. The accounts of the other non-sterling area countries were known

¹ An important item in this category is the remittance of the current trading profits of the United Kingdom subsidiaries of foreign companies. This is permitted but requires careful inspection to approve the way in which the figure for profits is arrived at and to ensure that outstanding tax liabilities have been met.

² This was of course possible because all Sterling Area countries in 1939 (with the unimportant exception of Eire) were co-belligerents.

as 'Special Accounts' and these were operated on a bilateral basis, the holders receiving payments for their exports to Britain in blocked sterling¹ which was not convertible either into their own or into any currency but was acceptable for payments throughout the Sterling Area.² The inevitable war-time deficit of Britain with other countries resulted in the gradual accumulation of sterling in these Special Accounts — the beginning of what were later to be called the 'sterling balances'.³ As the war proceeded the strict bilateralism of Special Accounts was relaxed by an element of controlled or administrative transferability and countries with large sterling balances were sometimes allowed to use sterling to buy from other countries, providing such countries were also prepared to hold blocked sterling balances. This was possible because as the war proceeded some few countries ran short of sterling while others held large balances.

In July 1945 a number of Central American countries (previously grouped and treated on a bilateral basis) were included with the existing United States 'Registered Accounts' to form a composite single group known as 'American Accounts'.

With the conclusion of the war and the liberation of Europe the strict bilateralism of Special Accounts had to be modified to suit the growing volume of trade and the movement towards sterling convertibility which had been agreed upon at Washington in December 1945 and embodied in the Anglo-American Loan Agreement.⁴ A number of bilateral payments agreements were concluded with European countries whereby the rate of exchange *vis-à-vis* sterling would be fixed and the European country would accept payment in sterling which it could use freely throughout the Sterling Area. These resembled the Special Accounts of the

¹ The willingness of countries to accept payment only in convertible sterling (as with the United States) or in blocked and inconvertible sterling (as with the Special Account countries) was the origin of the distinction between 'hard' and 'soft' currencies.

² It should be noted that the disadvantage of the bilateral character of these Special Accounts was to some extent mitigated by the fact that on one side stood not one country but all the countries of the Sterling Area.

³ The willingness of the Special Account holders to accumulate sterling may be ascribed partly to belief in the future of sterling and partly to the fact that since Britain was their traditional market they had little option. In one or two cases, where countries supplied important strategic materials, they were given exchange or gold guarantees in respect of their sterling balances. This was not, of course, generally known at the time.

⁴ Cf. *Financial Agreement between the Governments of the United States and the United Kingdom*, December 6, 1945, Cmd. 6708, Clause 8 (ii).

war years but differed from them in that they were more liberal and allowed for such limited transfer as might be granted by the Bank of England, and in that, in some cases, mutual indebtedness over an agreed amount had to be settled in gold. Early in 1947, as Britain moved towards the date on which sterling was to be made convertible (July 15) an important modification took place in the establishment of the system of 'Transferable Accounts', under which a number of countries were given the right to transfer sterling between themselves and in the Sterling Area, in respect of current transactions, without reference to the Bank of England.¹ Thus, within a growing number of countries outside the Sterling Area sterling was the means of international payment.

The obvious next step towards convertibility was to bridge the gap between Transferable and American Accounts, and in February 1947 the sterling held by Transferable Account countries was made fully convertible into dollars. Moreover, between February and July of that year, an increasing number of countries was placed on the Transferable Account list until, on July 15, sterling was freely convertible. In this way Britain moved gradually towards convertibility of sterling well in advance of the date required under the terms of the Loan Agreement.²

For a number of reasons the convertibility experiment failed. During late July and early August the drain from the Sterling Area gold and currency reserves was such that on August 20, 1947 convertibility had to be suspended by the simple means of stopping the free transfer of sterling between Transferable and American Accounts. This had various effects on the payments system. The American Account countries were hardly affected at all inasmuch as they could still change all sterling accruing to the accounts into dollars. What did affect them was that the dollar shortage, which had been in great part responsible for the failure of the convertibility experiment, forced both Britain and the Sterling Area to discriminate against dollar goods. The Transferable Account countries suffered by the suspension. Some opted

¹ This right of transfer was subject to the approval of the monetary authorities of the countries concerned and to the transfers being in respect of current transactions. There was thus an incentive to include under Transferable Accounts only such countries as could be relied upon to honour their obligations.

² The only exceptions to general convertibility on July 15 were a few countries (e.g. China, Greece and Hungary) where political conditions made it difficult to negotiate the necessary agreements.

to continue their Transferable Account status, which now meant that sterling accruing to them could be used only in the Sterling Area or in other Transferable Account countries while some reverted to a bilateral status similar to that of the old Special Accounts.¹

The convertibility failure then left five distinct groups in the sterling payments system which was to endure in this form until March 1954. First, the Sterling Area itself within which there was free transfer of sterling. Payments into the Area were to be made in sterling, payments outwards only on the authority of the British Exchange Control, or that of the country in which the payer lived. Secondly, there were the American Account countries whose sterling was transferable to any country² and convertible into dollars. Thirdly, the Transferable Account countries who might transfer sterling to other such countries for current payments, but might not change it into either their own or any other currency, and who might also use it to purchase goods and services anywhere in the Sterling Area. Fourthly, bilateral countries whose sterling earnings were not convertible into gold or dollars and only into any other currency on the special permission of the British authorities, i.e., by administrative transfer. And fifthly, a small group of unclassified countries with whom there was no special arrangement, cases being dealt with by the British authorities as they arose.

Between 1947 and 1954 this grouping changed little. Sterling payments remained predominantly bilateral and the only element of multilateral transferability (outside the Sterling Area itself) was among eighteen countries which, until March 1954, comprised the Transferable Account group. Only when a country agreed to accept sterling from any other Transferable Account country and from the Sterling Area in respect of current transactions and when it agreed not to transfer sterling to other Transferable Account countries save for current transactions could it become eligible for membership of the group. But these conditions came to be

¹ This meant that such countries would accept sterling up to a prearranged amount in excess of Sterling Area earnings of their own currencies, — this amount being known as 'the swing'. Such countries could use their sterling to buy in the Sterling Area or in such other countries as the British Exchange Control would approve. After August 1947, however, difficulty was experienced among the European economies because of Britain's refusal to approve transfers of sterling and her insistence on bilateral balancing to avoid loss of dollars on the Continent.

² There were minor exceptions. Transfer of sterling to certain countries on the 'bilateral list' was subject to administrative approval by the British authorities.

flouted and in active free markets abroad sterling changed hands (and was even convertible into dollars) at discounts relative to the official rate. On March 22, 1954 (by when sterling had hardened and discounts had become negligible) all non-sterling countries outside the dollar area were included in the Transferable Account group¹ and all restrictions on the use of transferable sterling were abolished, even to allowing it to be used for capital transfers. The barrier between Transferable Accounts and American Accounts remains² and must do so until the day of full convertibility, but the mechanism of sterling payments has been greatly simplified and simplification can scarcely be carried further save by convertibility itself. All sterling is now (1956) of three types: first, sterling held by Sterling Area residents and usable in the Sterling Area only; second, American Account sterling which is fully convertible into dollars at the official rate; and third, the now extended transferable sterling which covers all remaining countries. Indeed, since the rate of exchange in the market for transferable sterling is now supported by the intervention of the Exchange Equalisation Account, it is arguable that, for non-Sterling Area residents, sterling is convertible either at official rates or at slight discounts.

The Sterling Area as we now know it is clearly a creature of the Second World War. The unified group of countries with a central reserve pool, the elaborate payments system which we have described, were the result of organising the area for economic defence. It emerged from the war in a unified and organised form but, although more tightly knit, it had to face new problems arising from the effects of the war and its position as a currency group in the postwar world. Since these problems and the way in which they have been met are an essential aspect of the co-operative character of the group we must examine them briefly. Two are of major importance. First, there is the problem of how, and under what circumstances, the limited convertibility of sterling, at present forced upon the Area by the dollar shortage, might be replaced by a wider or even full measure of convertibility. Second, there is the capital indebtedness of the United Kingdom to the Overseas

¹ With the minor exceptions of Hungary, Turkey and Persia.

² It should be noted that in the reopened London gold market gold could not be bought by transferable account holders. It could, however, be bought for American Account sterling or against a new category of non-resident sterling known as 'registered sterling' which can be acquired only by United States or Canadian dollars or gold by a resident external to both the American Account and Sterling Areas.

of view — that in a two-centre system movements of funds from the weaker to the stronger centre must be expected from time to time when, for any reason, confidence in the former is impaired. If sterling is to be made convertible it must be strong enough to bear this burden, which is an inescapable cost of dual-centred multi-lateral payments. Yet only under multilateral payments can the maximum advantage be derived from international trade and division of labour, only in such a world will the Bretton Woods system function in the way for which it was planned. These are global arguments, but there exists from the narrower angle of the Sterling Area itself an inducement to rehabilitate sterling for the advantages which its more widespread use would yield. Among these would be the enhancement of the central financial position, the prestige, and the earning power of the city of London. Such inducements have impelled the adoption by the British government of convertibility as a primary policy aim.¹ Thus, there are weighty abstract arguments both global and unilateral in favour of a restoration of sterling convertibility.

Since the end of World War II there has been a steady progress from bilateralism in foreign trade in the direction of freer payments — a movement from bilateralism to regional clearing, which began in Europe with the Multilateral Compensation Agreement of 1947, was continued in 1948 and 1949 with the First and Second Intra-European Payments Agreements and fructified in the establishment of EPU and the linking of that regional group with the Sterling Area. Convertibility, when achieved, will thus complete a process of liberation.

The abstract case in favour of convertibility is convincing enough, yet it is not these immutable economic truths which govern the march of events, but rather the policies of governments impelled by many immediate and short-term considerations which present themselves in clamant fashion and make progress towards the ultimate goal difficult.² It is not surprising that, in face of these immediate problems, there are many who claim that direct

¹ The Commonwealth Conference of 1952 saw the beginning of a new British drive for a convertible pound. The so-called 'collective approach' was then devised whereby Britain, the RSA, and the United States would all contribute measures to bring about early convertibility.

² For example hopes of early convertibility ran high in 1954 and early 1955 under the stimulus of a favourable Sterling Area balance of payments and mounting reserves, but slumped again in late 1955 and 1956 with a renewal of the foreign balance problem and dollar shortage.

controls over payments are the best method open to governments for dealing with deficits and surpluses in balances of payments, and who are loth to discard them in the interests of what seem to be rather hypothetical advantages.

Turn now to our second problem — the present extent of, and means to widen, convertibility. Briefly, convertibility in a currency is the power of exchanging it freely in a public exchange market for other currencies.¹ It is then, not an absolute matter, but one of degree. One may be able to convert currency A into currencies B and C, but not into currencies D and E. We are therefore concerned, in examining the convertibility of the pound, to find what currencies it may be exchanged for. Full convertibility will be established when holders of sterling have complete freedom to dispose of sterling balances in any way they think fit, either to make payments in Britain, in the Sterling Area, in Federal Germany or to change a sterling balance into dollars and discharge a debt in the United States. It is this latter right which is at present denied to holders of current sterling.² Under the present exchange control a wide measure of convertibility for sterling earnings already exists, and foreign holders of sterling may use their balances in Britain, the Sterling Area, and the countries of the Transferable Account group. Next to the dollar, sterling is the leading international currency, freely convertible over a great part of the globe. But it is not convertible into dollars and at present sterling stands, relative to its exchange control, in a similar position to that of early 1947 when it required only reciprocal conversion of Transferable and Dollar Account sterling to complete a system of non-resident convertibility.³ On the day when the Chancellor places a bridge

¹ This is a simple working definition. Those who desire refinement should consult A. O. Hirschman, 'Types of Convertibility', *Review of Economics and Statistics*, February 1951, pp. 60-2.

² In fact the Overseas Sterling Area at present enjoys what is called 'central bank convertibility' in that the central banks or central monetary authorities of these countries have legal right to use sterling to make payments to any country. This right is of course denied to individual traders and is used with great restraint even by the central authorities who discriminate against dollar imports in the interests of Sterling Area reserves. There are three other forms of modified convertibility: that which exists through the process of 'commodity shunting'; that which exists under the present EPU arrangements where chronic debtors of the Union settle their debts in gold, and that which exists for holders of transferable sterling who may exchange this for dollars in certain free markets at a discounted rate.

³ Distinction must be made between 'non-resident convertibility' and 'resident convertibility'. The former implies a system where conversion of sterling into foreign currencies is permitted only to foreigners acquiring a

across the gap which at present separates the Transferable Account countries from those of American Accounts convertibility, in the current usage of the term, will have been achieved.

In this way the pound can be brought to convertibility but several subsidiary aspects of such convertibility must be decided. First, if non-resident sterling is to be made convertible, should this privilege be given only to sterling which is currently earned or should it be extended to include sterling which has been acquired in the past and is at present held as a balance in the Sterling Area? There are two sides to this question and the answer lies in assessing the balance of advantage. On the debit side there is the fact that, in so far as old balances are freed for current use, they may be used by the foreign holders to finance imports from the Sterling Area while these same foreigners convert their current sterling earnings into dollars. If this were to happen to any considerable extent it would have deleterious effects upon the Sterling Area balance of payments. On the credit side it can be said that a main aim of making sterling convertible is to restore its position as an international currency and make it a desirable currency to hold. The spectacle of old balances remaining frozen would hardly inspire such confidence. On balance it is probably wiser to extend convertibility to all sterling, whether in long-standing balances or currently earned. The sterling balances held by foreigners in London, which would once have proved such a menace, are now little in excess of necessary reserve requirements, and, where they are so, they are the subject of special agreement.

Second, we may ask whether convertibility of non-resident sterling is to be accorded alike for current and capital transactions? Here again, the answer must surely be that if convertibility is worth the candle at all, it is only worth it to restore sterling's international status, which can only come if foreigners are confident that they can move balances freely in and out of sterling. As long as there is restricted use of sterling, for any purpose, then sterling must be at a disadvantage relative to the dollar. Moreover, there is the difficulty of exchange control, for experience has shown that, in order to control capital transactions, all current transactions must be scrutinised. This would mean the retention of sterling balance from the proceeds of current trade; the latter implies the full right of all persons resident within the Sterling Area to acquire foreign currencies at will for any purpose. It is generally assumed in Britain that, initially, sterling convertibility means convertibility for non-residents only.

the exchange control mechanism. Indeed it might well have to be strengthened, for if Transferable Account countries, on whose controls Britain at present relies, were to dismantle their controls when sterling became convertible, the result would be to throw an additional burden on the British control. If sterling cannot be made convertible for non-resident balances with the advantages of convertibility for past as well as present earnings and convertibility for capital transactions, then the establishment of convertibility should be delayed until the strength of the currency permits of such conditions.

Finally we turn to our third question: what are the minimum safety conditions which must be satisfied before the final step to make sterling convertible is taken? Of these there are three and we shall deal with each briefly.¹ First, since the controls, whose retention ensures the inconvertibility of sterling, are all aimed at giving protection to the British and Sterling Area balances of payments, the removal of these must wait upon such equilibrium and stability in the balance as renders them no longer necessary. In particular, the balance of payments of the Sterling Area with the Dollar Area must exhibit present balance, and a reasonable prospect of balance in the future — a condition which is doubly important in that European countries will no doubt seek to earn dollars by exporting to Britain. To approach convertibility in the absence of this condition would be folly, any deficit, either in the overall or in the dollar balance, immediately imperilling Sterling Area reserves. But this raises a further question. In so far as the dollar problem has been held in check this has only been achieved by the use of import controls (and exchange controls) which discriminate against dollar imports. Just what the balance of payments with the Dollar Area would be in the absence of such controls it is impossible to say, but it is certain that the removal of discriminatory controls would weaken the balance. The question therefore arises as to whether convertibility of non-resident sterling should be established while these controls are still in being; whether the strength of sterling should be tested under their protection, and, as confidence grows and sterling maintains its position, the controls should be dismantled, or whether alternatively the discriminatory controls should first be abolished and, if an appropriate balance still re-

¹ These are, of course, the conditions laid down by the then Chancellor of the Exchequer, Mr. R. A. Butler, in 1952.

mains, sterling should then be made convertible. There is something to be said for either course. Whichever is adopted, sterling will finally be required to stand firm, convertible into all foreign currencies and unsupported by discriminatory controls.

The balance of payments surplus required to sustain convertibility must be not only durable but large — large enough to bear the weight of several claims which would be made upon it. One such claim is that of the population and industries of Britain. If foreign-held sterling is to be freely convertible into dollars, many foreign countries may turn the sterling proceeds of their exports to Britain and the Sterling Area into dollars, thus placing such a strain upon Sterling Area reserves as to make it necessary for Britain herself to limit her own dollar outlays in order to support her convertible currency. It would be sad if, by making sterling convertible, Britain solved other countries' dollar problems but not her own. Yet this danger is a very real one. The immediate beneficiaries of convertibility would be the European countries for most of which the dollar is still a scarce currency. It is not inconceivable that, conducting export drives in the Overseas Sterling Area, certain countries might apply restrictions against Sterling Area imports in order to acquire the desired sterling surplus. Certainly all the pointers are that, at least initially, we would have to meet selling pressure on sterling. To meet this contingency we must have a big external balance on current account and the backing of large reserves. A second claim on a current surplus in the foreign balance must necessarily come from the Overseas Sterling Area who have for years practised dollar abstinence and restricted dollar imports in the interests of the stability of the Area. It is not unreasonable that, with an expanding surplus, these countries will expect to expand their imports from the dollar area. Are they then to be told: 'No. You must practise further abstinence, indeed it may be necessary for you to intensify it.' It would be unwise. These countries need dollar imports. We must not strain the links which bind the Sterling Area too far.¹

Lastly, from the surplus we must also meet heavy long-term commitments for overseas investment both in the Sterling Area

¹ It must be remembered that, under existing arrangements of central bank convertibility any unwillingness on the part of OSA countries to accept continued dollar restriction would be reflected in less restraint in the matter of dollar imports. This would imperil Sterling Area reserves.

and outside it. To develop the so-called backward countries is a duty which lies heavily upon the mature economies.

All of these claims press upon the favourable balance which is a prerequisite of convertibility. Clearly the costs of establishing and maintaining sterling as a convertible international currency will be considerable. We must think well. It has been, perhaps too readily, assumed that the rehabilitation of sterling as an international currency is an unquestionable aim. In fact the convertibility step involves Britain and the Sterling Area in certain costs which must be weighed against the hypothetical advantages. The greatest of these advantages is said to be the establishment of sterling as an international currency with all the increased financial and banking earnings which would thereby accrue, but, before accepting this, we must be satisfied that the costs to be borne are justified by these additional earnings and indeed whether, over a long span of years, Britain is now economically and financially capable of playing the role of the weaker centre in a dual-centred payments system.¹

The second safety condition of convertibility is that of adequate reserves. Britain should anticipate a temporary run on sterling immediately after convertibility is established, while there is likely to be some temporary reduction of sterling balances while foreigners observe the progress of the convertibility experiment. Later, fluctuations in world demand coupled with speculative selling of sterling must be expected. It would be difficult to settle upon any given figure of reserves which would make convertibility possible. The amount of calls upon reserves cannot be predicted² depending as they do upon the future of the Sterling Area's balance of payments and upon the pressures upon sterling when it assumes the role of world currency. It seems certain, however, that such reserves as the Sterling Area at present possesses, or is likely to acquire (by her own unaided efforts) in the near future, will be inadequate — even if the strain upon them is cushioned by a floating exchange rate for sterling.³ If lack of reserves were all that

¹ Mr. Alan Day believes that she is not capable of this role. See his book, *The Future of Sterling*, Oxford 1954, which is a well-planned discussion of this topic.

² In 1938 the ratio of Britain's reserves to Sterling Area imports was of the order of 50 per cent. Application of this ratio to present imports demands a reserve requirement of some \$10 bln. Present reserves stand at \$2,084 mln (February, 1957).

³ Even with a recurrent annual surplus of \$200 mln in the British balance of payments five years would be required to add \$1,000 mln to the reserve. It is arguable that the investment of such an amount in modernisation of British industry might do much for the solution of the long-term dollar problem.

prevented convertibility, however, it seems possible that from some source additional liquidity could be obtained. The negotiation of a large IMF standby-credit, perhaps with the addition of a Federal Reserve stabilisation loan, would be greatly facilitated if the American government were assured that it would result in a convertible pound.

And finally, since the maintenance of a strong and convertible pound must depend largely upon the Sterling Area balance of payments with the United States, it is proper that Britain should demand from that country concrete proof that it will pursue a more liberal commercial policy. It should be a minimal condition that the United States should implement the measures proposed in the Randall Report. It should be made clear to the Americans that, in the presence of such monumental absurdity as their present protective trade policy, all efforts to restore the multilateral trade for which they make such clamant demands must necessarily be impaired.

It has been impossible in short compass to do more than place the elements of the sterling convertibility problem before the reader, thus helping him to form his own judgements. The basic conditions upon which convertibility must depend are not satisfied at present (late 1956) and in these days the economic weather changes often and is difficult to predict. By the time these lines are read much may have happened. It is, however, well to conclude with a word of caution. Too often convertibility of sterling is regarded as an end in itself. It is not an end, but a means of establishing a condition in which we believe trade will flow more smoothly and abundantly. Even successfully established multilateralism will bring its problems — particularly for the Sterling Area. We must not come to regard convertibility in the way in which our fathers regarded a restored gold standard, as a terminus of effort. In fact it is only the beginning of a journey.

IV

External assets of the Overseas Sterling Area and some other countries are held as balances in London. In 1931 the short term overseas liabilities of London were estimated to be £407 mln.¹ In August, 1938 they were £760 mln and at the outbreak of war

¹ Cf. *Report of Committee on Finance and Industry*. Cmd. 3897 of 1931, p. 112.

£476 mln. As a result of the cost to Britain of financing the war these balances were enormously increased and at June 30, 1945 they stood at well over £3,000 mln. Most of these United Kingdom liabilities were to the OSA but a considerable sum was owing to foreign countries — to Egypt, Palestine and a number of European and Latin American countries. Clearly these sterling balances were, in 1945, far in excess of what was appropriate for monetary reserves,¹ and the natural inclination of the holders was to use their surplus sterling for purchases in Britain. Another desirable course, from the point of view of the holders would have been to convert surplus sterling into some other currency, preferably dollars, and use these to make purchases elsewhere. Both of these courses were equally impossible for Britain. British productive capacity was unequal to the potential demand and wholesale conversions would have jeopardised the Sterling Area's meagre reserves of gold and dollars.² Throughout the war the balances had been a form of forced saving and, although nominally liquid, it had proved impossible for the holders to draw upon them, but as war ended the voices of holders demanding payment were becoming louder.

Clearly if excessive pressures upon the United Kingdom economy were to be avoided some ordered method of dealing with these balances was required. Bilateral negotiations were therefore instituted between the United Kingdom and the countries concerned as a result of which agreements were reached in late 1947 with regard to the use of the balances. These agreements provided for the temporary blocking of the balances of some countries — India, Ceylon, Iraq, Palestine, Egypt, Argentina, Brazil and Uruguay — and for restraint in the use of balances by others — Australia, New Zealand, South Africa, Eire, and the Colonies.³ For those countries whose balances were blocked, two accounts were created for their central banks at the Bank of England. The No. 2 Account was blocked, and was to hold previously accumulated sterling. From this, amounts were released to the No. 1 Account only by mutual Agreement, while in the No. 1 Account

¹ Even considering the rise which had taken place since 1939 in prices and volumes of trade.

² The gold reserve in June 1945 stood at £453 mln as compared with £864 mln in August 1938.

³ All blocking was for a time on a short-term basis and the relevant agreements had to be frequently renewed. Clearly such an arrangement divided the Sterling Area into two groups, one of whom could be trusted to behave with due regard for the scarcity of the dollar, and one who could not.

were accumulated, in addition to such releases, balances accruing after the date of the agreement. All No. 1 Account balances were freely available for current use.

Table VII shows the sterling balances outstanding at the end of the war and at June 30, 1954.

TABLE VII
Holders of Sterling Balances
(£ mln)

<i>Sterling countries</i>	<i>At June 30, 1945 (a)</i>	<i>At June 30, 1954 (b)</i>
India and Pakistan - - -	1,138	640
Australia - - -	118	405
New Zealand - - -	63	120
South Africa - - -	33	50
Ceylon - - -	68	50
West Africa - - -	93	400
East and Central Africa -	133	260
Malaya - - -	87	300
Hong Kong - - -	33	120
Burma - - -	—	65
Iraq - - -	70	70
Eire - - -	178	190
<i>Non-sterling countries</i>		
Egypt and Sudan - -	402	180
Argentina - - -	86	15
Portugal - - -	79	85
Other West European countries - - -	160	220
Japan - - -	—	30

Source: (a) Report of Committee on Postwar Economic Policy and Planning of the United States House of Representatives, 1945.

(b) *The Banker*, February 1955, p. 83.

Releases from blocked sterling balances have been substantial and large amounts have been transferred each year from No. 2 to No. 1 Accounts. Overall releases from blocked balances have been officially given as follows: £5 mln in 1946, £156 mln in 1947, £267 mln in 1948, £218 mln in 1949, and £126 mln in 1950. Between 1946 and 1949 the balances of India, Pakistan and Ceylon seem to have been reduced by about £360 mln and the Colombo Plan contains provisions for their annual reduction by £45 mln over the six years 1952-57 by the end of which time these balances should be at

TABLE VIII

Total Sterling Balances and Gold Reserves 1945-56
(£ mln)

	June 30 1945	Dec. 31 1950	June 30 1951	June 30 1954	June 30 1956
Sterling countries ¹					
United Kingdom					
Colonies - -	- 670	735	908	1,183	1,301
Other £ area - -	- 1,628	1,999	2,192	1,741	1,600
Non-sterling countries ²	- 902	1,011	1,068	689	649
Total of sterling liabilities to all countries - -	- 3,200	3,745	4,168*	3,613	3,550
United Kingdom gold and dollar reserve - -	- 453	1,178	1,381	1,078	852

* Postwar peak of sterling balances.

Source: United Kingdom Balance of Payments 1946 to 1956. Cmd. 9871.

a minimum level. In 1951 the agreements with India, Pakistan and Ceylon were made more flexible in accordance with the greater strength of sterling and with the proved goodwill and administrative competence of these countries. Indeed, with the strengthening of sterling, the distinction between No. 1 and No. 2 Accounts came to be more formal than real. The large balance of Egypt had been reduced from £400 mln in 1945 to £230 mln in 1951 and a working agreement provided for a progressive reduction of this figure by a series of annual releases. The Egyptian balance in October 1955 was £128 mln. As for West European countries the outstanding balances in 1950 were embodied in the EPU agreement and debtors to Britain were allowed to use balances to clear deficits with Britain in the Union. Thus under release arrangements the excess balances have been largely worked off and the present figure is little in excess of trading and reserve requirements. Table VIII shows the changes in the total sterling balances since 1945.

The release of blocked balances has been severely criticised by many in Britain; partly on the economic grounds that it has imposed a severe burden of unrequited exports upon the economy and was in great part responsible for the failure of the 1947 ex-

¹ India, Pakistan and Ceylon classed as 'other sterling area'.

² Egypt classed as a non-sterling country.

periment in convertibility; partly on the non-economic ground that since we had helped to defend many of these balance-holders they had no moral right to demand payment from us for goods and services rendered.¹ It was argued that the Americans had given generously to the war effort in the form of Lend Lease, yet our own colonies and dominions (and the defended neutral, Eire) were presenting their several bills for war-material. Two reasons, however, no doubt prompted the British Government to repay the balances: the fact that such repayment was likely to contribute to Sterling Area solidarity during a critical phase in the group's history,² and the fact that such releases financed a significant flow of essential supplies to underdeveloped countries. It is no exaggeration to say that in the latter respect sterling balance releases constituted a useful forerunner of the Colombo Plan.

Side by side with the progressive scaling down of the blocked sterling balances there has been a steady postwar growth of free balances. Unblocked balances increased by some £800 mln between 1946 and 1950. Much of this increase has been attributable to large sales of primary commodities to the United Kingdom by the Overseas Sterling Area, to the sharp rise in primary commodity prices during the period, and to capital movements within the Sterling Area. Although the total amount of sterling balances at present is large, the problem is less acute than in the immediate postwar years. The balances are now held predominantly by countries within the Sterling Area whose policies are not likely to be inimical to the interests of the group, and the wartime balances have virtually been disposed of. Moreover, the sharp rise in the world price level since the war has not only reduced the real burden of sterling debt, but made it necessary for Sterling Area countries to

¹ Sir Winston Churchill was a trenchant critic of the claims of such countries as Egypt for sterling balance repayment. As Leader of the Opposition he was both well placed and well informed for an attack upon the Labour Government's handling of sterling balances. Had he remained Prime Minister, he declared that he would have insisted upon a complete enquiry into the whole problem and a more equitable distribution of the cost of the war as between members of the Commonwealth. It seems that the Government were seriously embarrassed in their wish for cancellation of balances by the fact that, at that time, they were negotiating the British withdrawal from India. To the Indians any suggestion that independence was being bought by them was odious and since they were the largest single creditor the maintenance of their balance ensured that of the rest. Australia and New Zealand made small voluntary cancellations.

² In fact the British Government did argue that some of the outstanding sterling balances should be cancelled but it agreed to recognise Britain's responsibility to honour the balances as liabilities. In the end only about 1 per cent of the original total of obligations was cancelled.

hold larger banking and foreign exchange reserves. It has been calculated that about £2,000 mln, out of total balances of £3,800 mln, are now needed as external reserves and backing for note issues. It seems probable that the Australian, New Zealand, South African, Middle Eastern and South American balances are at or near their minimum level.¹ Of the remainder of the total balances, part is held by the Colonies and is therefore under the direct control of Whitehall.

Lastly, it should be noted that this large volume of war-accumulated balances has had some influence on the pattern of postwar trade. As the balances were not convertible into dollars, but were progressively released and made available for the holders to buy goods in the Sterling Area, this constituted discrimination in favour of sterling exports and against dollar exports. No doubt it was this fact which led the Americans to force Britain to include a clause in the Washington Loan Agreement whereby the balances were to be made convertible into dollars.² This clause perished with the general failure of sterling convertibility in 1947 and thereafter the American pressure for converting the balances eased. It is impossible to estimate the influence of this great inconvertible sterling purchasing power upon the trade pattern of the late 'forties, but it may for a time have been considerable. By 1951, however, the reduction of the balances, the rise in world prices which reduced their real value, and the necessity for sterling countries to hold larger monetary reserves all served to reduce this discriminatory influence. The sterling balance problem as we knew it has virtually ceased to exist. It may be, however, that it will emerge in a new form. The large development plans of Commonwealth countries will result in capital imports from Britain and elsewhere which will be paid for in sterling. We must, therefore, expect drawings upon these balances in the future and take appropriate steps to meet this.

V

The Sterling Area has been built upon a basis of mutual advantage. That a grouping of countries, each with its currency unit

¹ Cf. A. R. Conan, *The Sterling Area*, London 1952, pp. 138-9.

² Cf. *Financial Agreement between the Governments of the United States and United Kingdom*, December 6, 1945. Cmd. 6708, clause 10.

linked to sterling, was advantageous to its members was evident from the experience of the years 1931-39 during which the Area was merely a fixed exchange rate group. The war and the economic problems resultant upon it forged the present group within the British Commonwealth. Economic self-defence was its *raison d'être* in 1939; it has continued to be so during the period of international payments disorder which has followed the war and the dollar shortage made its continuance inevitable. We have already touched upon other cohesive forces which bind the members of the group, but it must be admitted that these are subsidiary. In the absence of mutual advantage and the furtherance of national self-interest these would not suffice to prevent the group from disintegrating. For the United Kingdom the Area provides a great market in which to buy primary products in return for manufactured exports; it provides in the dollar pool some contribution to its own dollar deficit and it provides the framework of a great monetary system through which sterling can circulate freely as an international currency. To the Overseas Sterling Area the group provides a market for its products in which it has preference as a supplier over non-sterling area countries¹ while at the same time it may export to foreign countries if it so wishes; it provides access to an area of multilateral trade in which both primary products and manufactured goods may be bought and sold for sterling; it means access to the London capital market; it means that it may participate in advantages which the group gains as a group and which it would have no hope of enjoying as a single country; and it has meant, for some, protection from the worst effects of dollar scarcity. These advantages have been sufficient to bind the Area and secure its continuance.

It is tempting to speculate upon which derives more advantage from the Area, the United Kingdom, or the Overseas Sterling Area, but since we are not likely to get far beyond speculation, it is best to forego this pleasure. In the main it seems likely that the honours are about even. Certain of the Dominions have grumbled that they might have earned more dollars for themselves had they not been obliged to export their goods to Sterling Area markets,

¹ That is other Sterling Area countries will, other things being equal, prefer to buy in a Sterling Area country where they may settle the debt in sterling, rather than in a foreign country where the purchase will necessitate an exchange with the foreign currency, which may be scarce.

mainly the United Kingdom. The United Kingdom may retort that she, on her side, husbanded the dollar pool by the abstinence of severe import restrictions only for it to be periodically raided for profligate spending sprees by the Dominions. Both claims have substance. Less is heard of the instability which is imparted to the group by its reliance for dollar earnings upon primary commodities whose prices are volatile, which yield large dollar earnings in boom and cause an intensified dollar gap in slump. It is arguable that if the dollar pool of the Area is to be replenished in the former and not to be swiftly depleted in the latter, something more than self-discipline in the matter of dollar imports is required. The time may be ripe for some formal organisation to co-ordinate policies within the Area. There is little doubt that absence of formal organisation at one time was advantageous: it is doubtful if it continues to be so.

No judgement of the Sterling Area as a force for international monetary co-operation is possible as it is in the case of an international organisation (e.g. IMF) or group of countries (e.g. OEEC) which has specific aims and can be judged relative to its achievement of these. The Sterling Area has been three things in its day: a fixed exchange rate club of countries with broadly similar interests and policies; a group organised for economic warfare; and a group organised for defence against the dollar problem. At no stage have objects been defined and for that reason critics of the Area's usefulness are forced to fall back upon dubious comparisons with hypothetical alternatives. From the viewpoint of the Area and its members, we must infer from its continuing existence and apparent strength that it yields mutual advantage over such alternatives as exist,¹ and we may note that international co-operative arrangements do not necessarily require detailed constitutions so that they may work. From the viewpoint of the world at large it has been advantageous that the Area has provided a great international system of multilateral trade carried on in sterling as an alternative to fragmented bilateralism; that this system has been administered with purpose, good sense, and, in the main, in the interests of world international monetary co-operation; and that it provides the easiest route towards world

¹ For a different opinion see C. A. R. Crosland, *Britain's Economic Problem*, chapter 7, pp. 144-80.

multilateralism in that convertibility of sterling into dollars will, when the time comes, achieve that end.¹

¹ We have avoided discussion of the problem of what will become of the Sterling Area once convertibility is achieved. By so doing we do not infer that convertibility is an end; rather it is a means to widen and expand world trade. When convertibility is established the justification for the Sterling Area must be viewed afresh. This raises a host of problems which would carry us far and wide over the field of world and Commonwealth trade and with which we have no space to deal. Mr. Alan Day has given us some food for thought on these problems in his book *The Future of Sterling*.



REGIONAL CLEARING SYSTEMS:
INTRA-EUROPEAN PAYMENTS¹

I

THE European economic problem in 1945 was elemental. To meet a well-nigh insatiable demand for goods of all kinds peace production had to commence and increase, and, in order that the produce of growing production could be distributed, international trade and payments had to be restored. We are concerned with the second of these tasks. Since Europe became divided into the rival political groups of East and West, we may confine ourselves to the problems of the latter.

The European payments problem was two-fold: each country had to earn enough by its exports to pay for the imports which were necessary for its life and the recovery of its economy, and, because trade in immediate postwar Europe was conducted on a bilateral basis, it was necessary that this should quickly be replaced by some system of payments which enabled countries to generalise their purchasing power.

Trade revived slowly on the basis of a series of bilateral payments agreements.² These were concluded between the governments of non-dollar countries according to a fairly uniform pattern. The central banks, as technical agents, supplied their own currency at a fixed rate of exchange against that of their partner, up to a certain limit, which was referred to as the 'swing', since it was intended to afford room for minor fluctuations in commercial de-

¹ Readers who require a fuller treatment of the European regional currency plans than that given below should consult W. Diebold, Jnr., *Trade and Payments in Western Europe*, New York 1952. The first part of this chapter owes much to Mr. Diebold's excellent account.

² At the end of 1947 there were ever 200 such agreements among European countries. By 1950 this number had nearly doubled. A typical example of a bilateral agreement was the Anglo-Belgian Agreement of October 5, 1944. Cf. *Monetary Agreement between the United Kingdom of Great Britain and Northern Ireland and the Government of Belgium*, October 1944. Cmd. 6557 of 1944, HMSO, London.

liveries between the two countries. Beyond the limit thus fixed, settlements had generally to be made in gold or a convertible currency. The rates of exchange provided for in the agreements were generally consistent and made a uniform pattern of cross-rates, but there were some exceptions, of which France, Italy and Greece were notable. Inflexible as these arrangements were they gave a limping start to European postwar trade.¹ Several countries including the United Kingdom, Belgium, Sweden and Switzerland augmented their bilateral agreements by export credits and the United Kingdom also granted a limited transferability of sterling in certain cases under the approval of its exchange control, and, after 1947, under the system of Transferable Accounts.²

The limitations of such arrangements were great and Europe's trade recovery was slow. Foreign trade did not increase as quickly as production nor did intra-European trade keep pace with extra-European trade.³ Countries which reached the limit of their swing would curtail imports from the other country which was party to the agreement, and for lack of currency, a debtor might cease to trade with a creditor for months on end. Clearly, if intra-European trade was to increase, arrangements had to be devised which would allow currencies earned in country A to be spent in countries B, C, and D. The task of European monetary co-operation has been that of enlarging the means to finance trade among European countries and of making currencies more widely acceptable.

By 1947 it was apparent that further expansion of European trade was being hampered by the bilateral trading system. ECA,

¹ The value of these bilateral agreements can best be judged by considering what would have happened if, in their absence, countries had sought to establish trade with convertible currencies. With reserves of international liquidity at a low level and, with a universal desire to earn dollars, trade between non-dollar countries would have been small. Countries would have been forced to seek external balance by a process of painful domestic deflation or, more probably by depreciating their currencies, a practice which might in some cases have led to hyper-inflation. Moreover, the bilateral character of many agreements was broadened by the fact that they were often made between monetary areas. For example, payments with Britain meant convertibility of sterling within the Sterling Area, those with Belgium included Luxembourg as well as the Belgian Empire, and those with France and Holland the overseas dependencies of these countries.

² Cf. *18th Annual Report of BIS* in which there is a review of these postwar bilateral agreements.

³ By 1947 industrial production was 83 per cent of 1938, and agricultural production 76 per cent of 1938, but in 1947 the volume of West European trade was only 59 per cent of 1938. Cf. *Economic Survey of Europe in 1948*. ECE, Geneva 1949, p. 134.

the organisation responsible for the allocation of Marshall Aid in Europe, reported that 'Practically no progress in the expansion of extra-European trade was made in the course of 1947 beyond the level reached during the last quarter of 1946'.¹ European recipients of aid reported in like vein that the bilateral system was breaking down, since margins of credit for many of the agreements had reached the limit of the swing and further trade had to be financed in gold.² (Gold and dollar payments between European governments were \$550 mln in 1947 and \$437 mln in 1948.)³ The dollar shortage was most acute in late 1947 and surplus countries were reluctant to provide credit while deficit countries were loth to use precious dollars to clear debts in Europe preferring to conserve them for imports from the United States.

During 1947 the Committee of European Economic Co-operation was meeting in Paris, and in the summer the Benelux representatives placed before the Committee of Financial Experts the draft of a proposed new arrangement for European payments.⁴ In essence this aimed at a wider transferability of currencies so that balances earned in one country might be used to liquidate debts in others. Although no conceivable scheme could dispense with gold and dollar settlements entirely it was hoped that, by some mutually agreed system of multilateral clearing, only residual balances of net debtors and creditors of the European group as a whole would require to be paid in gold. The Benelux experts argued that, since the net creditors of the group were likely to be at the same time debtors to the dollar area, they should be paid for their European surpluses in dollars which would be given by the U.S. as Marshall Aid to the European debtor countries. Such a scheme would be an advance upon the bilateral system, but it depended on a number of uncertain factors; upon the ability to offset indebtedness within Europe itself and upon the main-

¹ ECA, *European Recovery Program, A Report on Recovery Progress and United States Aid*, Washington 1949, p. 205.

² Cf. Account given in *18th Report of BIS*, p. 146.

³ Cf. IMF, *Balance of Payments Yearbook 1948*, pp. 36-7.

⁴ For the Benelux proposal see 'Report of the Committee on Payments Agreements', *General Report, Committee of European Economic Co-operation*, Paris, vol. II, Appendix C. The Committee for European Economic Co-operation, (CEEC) was the forerunner of the Organisation for European Economic Co-operation (OEEC). The latter came into being in 1948, as the organisation set up by the European beneficiaries of Marshall Aid. The Economic Co-operation Administration (ECA) was the official American body set up to administer the Marshall Plan.

tenance of a reasonably balanced structure of trade within the group without chronic creditor and debtor countries. Arrangements would have to be made for as wide a transferability of currency earnings as possible and, since general transferability was, for the moment, out of the question, a start should be made by a system whereby transference of a currency should be made on the approval of the country whose currency was to be transferred. Much depended on the willingness of countries to allow this.¹

During the autumn of 1947 a Committee on Payments Agreements sought to give precise form to the general proposals of the Committee of Financial Experts. The Benelux representatives proposed a clearing pool. Month by month the net debtor or creditor position of each country in relation to all the other countries of the group would be worked out and the debts of each net debtor country divided among the creditor countries in proportion to the share of each in the total export surplus. The resultant debts would then be dealt with in accordance with the terms of existing payments agreements. Thus a debtor country would only require to settle in gold and dollars with those creditors with whom its debts exceeded the stipulated credit margin. Since the debts of deficit countries would be spread over a number of countries the likelihood of having to make dollar settlements would be reduced.²

At its final meeting in Paris in October the Committee abandoned the pooling scheme and turned to a draft agreement embodying different principles. The new draft provided for first and second category compensation. Month by month participant countries would report to a central office their debtor and creditor positions with each other participant. The central office would then work out the maximum multilateral compensation possible without increasing the balance of any country. These offsetting debts, which would thus be settled automatically, were known as 'first category compensations'. Multilateral compensation which necessitated increasing any national balance was rated as a 'second category compensation' and required the consent of all countries involved.

This scheme was embodied in the First Agreement on Multilateral Monetary Compensation which was signed on November

¹ Unwillingness to consent to general transferability was to prove a major difficulty in Intra-European Payments Schemes.

² An advantage from the point of view of debtor countries but a disadvantage for creditors which they were not slow to realise.

18, 1947 by France, Italy and the Benelux countries.¹ Eight other countries² joined as 'occasional members', agreeing to report their monthly positions and consider proposals for compensations. The BIS was to act as central office, collecting data to make the automatic compensations, and proposing others to members. The Agreement operated from December 1947 until September 1948, when it was superseded by the first Intra-European Payments Scheme. Provision for final settlement, after first and second category compensations had been made, was left to existing bilateral payments agreements. In November 1947 when the Agreement was negotiated, the future of Marshall Aid was uncertain. The debates on ERP had not yet taken place in the American Congress and, for this reason, it was impossible to link the Multilateral Monetary Compensation Agreement with dollar grants to European debtors, as had been proposed by CEEC. Among the European countries the desire to conserve and to earn dollars was paramount, and attitudes towards this (and subsequent) agreements were determined by the desire to expend as few dollars in intra-European settlements as possible.

The operation of the Agreement was disappointing. Eleven countries took part in the final clearing in December 1947. These had debts with one another of \$762.1 mln, but of these only \$1.7 mln or .2 per cent of the total were cleared.³ For this low figure several reasons are given.⁴ Firstly, a number of members were net creditors of the group as a whole, while others were net debtors. No clearing system could reduce these debts, which accounted for a large part of the total — the BIS estimating them to be about \$400 mln in the first months of 1948.⁵ Secondly, of the various possible first category compensations all concerned occasional members and could, therefore, only be cleared with their consent. A number of key countries withheld their consent thereby blocking many other clearings. Thirdly, few countries would agree to

¹ The British and American Zones of Western Germany joined later.

² These were the United Kingdom, Sweden, Norway, Austria, Portugal, Denmark, Greece, and the French Zone of Western Germany.

³ Cf. R. W. Bean, 'European Multilateral Clearing', *Journal of Political Economy*, October 1948. Bean estimates that if all possible first category compensations had been made it would have been possible to clear \$39.2 mln in the first month. With the pooling system proposed by the Benelux countries, he estimates that \$278.9 mln might have been cleared.

⁴ Cf. W. Diebold Jr., *Trade and Payments in Western Europe*, New York 1952, pp. 25-7.

⁵ Cf. *18th Annual Report of BIS*.

second category compensations. The BIS estimate was that the possibilities for first category compensations were \$30-\$50 mln while possible second category compensations were probably five to nine times as great. These factors operated during the lifetime of the Agreement and resulted in its having only slight influence upon intra-European trade. Total clearings came to only \$51.6 mln of which \$5 mln were first and \$46 mln were second category compensations. Although the BIS tried to see a brighter side of the scheme¹ a more disinterested commentator² was probably near to the truth when he said that 'the measure of success so far achieved has done little to prevent the contraction of European trade'.

While the Multilateral Monetary Compensation Agreement was in operation no direct aid for the scheme was given by the United States. Instead the ECA Act of 1948 authorised ECA to grant dollars for 'off-shore purchases'. Countries taking part in ERP were thus given dollars to make purchases outside the United States.³ Most of such purchases were made in Canada and Latin America but a few ERP countries were given dollars in order to buy from other ERP countries. These dollars were regarded as aid to the selling countries who could use the dollars thus acquired in order to buy in the United States. The amount of trade financed by off-shore purchases in 1948 was much greater than the debts cleared under the Compensation Agreements. Nevertheless, the Americans disliked the system. It was not easy to ensure that dollars found their way to those countries most in need of them, while the scheme encouraged dollar-hungry European creditors to demand payment in dollars for their exports to other ERP countries.

The first Intra-European Payments Agreement was signed in October 1948. By then the ERP had been launched and, under the impelling demand for European economic integration which came from ECA, the new agreement involved all the countries of the new OEEC and embodied provisions for the allocation of American aid for the fiscal year 1949. Indeed, an effective European Payments scheme had become a necessity. The total applications of OEEC countries for aid exceeded ECA's appropriation. Clearly some countries were asking for dollars to buy in America goods which

¹ *ibid.*, p. 148.

² Cf. R. W. Bean, *op. cit.*, p. 408.

³ The Americans placed certain conditions on the making of off-shore purchases. For example, countries were not allowed to use such funds for the off-shore purchase of agricultural produce in surplus in the United States.

could be bought in Europe. To the extent that intra-European trade could replace dollar imports for the OEEC countries the task of allocating the available dollar funds would be easier. The Committee of Four, appointed by OEEC to reconcile national requests with the total aid available, assumed, therefore, that there would be an effective scheme for European payments.

Negotiating the Agreement was not easy. In July 1948 the Council of OEEC approved the principles but, in the weeks which followed, the Committee of Four made no progress towards a detailed agreement. A Committee of Five was then set up to supervise and expedite the negotiations. The principle of the proposed new agreement was that participating countries with European surpluses should make gifts of these surpluses to their debtors in return for 'conditional dollar aid'. The import and export programmes between OEEC countries were left to bilateral negotiations in which a planned trade balance for the year would be settled. Here controversy lay. Creditors, it seemed, were to give away surpluses; debtors it was argued were to get free imports. Countries who, under the off-shore purchasing scheme, had canvassed their exports in Europe for dollar sale, now seemed to suffer from mysterious export famines.¹ Moreover, countries were conscious of the fact that, in committing themselves to planned trade balances for a year, they were giving a hostage to fortune. Each country had its own fears. The United Kingdom, with the failure of the 1947 convertibility experiment freshly in mind, was fearful of losing dollars to Europe. Belgium, confident of a European surplus, wanted the maximum amount of dollar aid in return for what she was to give away. At length, after long negotiations,² after intervention by ECA and the OEEC Committee of Five, seventy-eight bilateral agreements were made and the final payments agreement was signed in Paris on October 16, 1948.³

¹ *The Economist* made acid comment: 'Only a few months ago there were surpluses under which the economy of these countries was apparently groaning and which could readily be put at the disposal of the rest of Europe if dollars were paid for them. But today these apparent surpluses have disappeared as if by magic. Under the new scheme if these surpluses entered into European circulation they would have to be given away. Consequently they no longer appear on the list of what is available.' Cf. *The Economist*, September 11, 1948, pp. 424-5.

² These negotiations often involved matters other than the immediate one of intra-European payments. Britain, for example, took the opportunity of forcing upon Italy the support of the pound/dollar cross-rate as reflected in the fluctuating markets for the lira. Cf. pp. 188 above.

³ Cf. 'Agreement for Intra-European Payments and Compensations of October 1948'. The text is printed in the *19th Annual Report of the BIS*, 1949.

TABLE IX
*ERP Dollar Aid and Intra-European Payments Scheme:
 July 1948-June 1949*

Country	Total dollar aid	Basic dollar aid	Intra-European payments scheme			Total dollar and net European aid
			Draw- ing rights grant- ed	Draw- ing rights re- ceived	Net re- ceipts (+) under IEPS	
			in millions of dollars			
Austria - - -	215	212	3	67	+64	279
Belgium-Luxembourg	248	29	219	11	-208	40
Denmark - - -	109	104	5	12	+7	116
France - - -	981	971	10	333	+323	1,304
Germany:						
Bizone - - -	411	302	109	99	-10	401
French Zone - -	99	84	15	16	+1	100
Greece - - -	145	145	—	67	+67	212
Iceland - - -	5	5	—	—	—	5
Ireland - - -	78	78	—	—	—	78
Italy - - -	555	508	47	27	-20	535
Netherlands - -	470	458	11	83	+72	541
Norway - - -	83	67	16	48	+32	115
Portugal - - -	—	—	—	—	—	—
Sweden - - -	47	12	35	10	-25	22
Switzerland - -	—	—	—	—	—	—
Trieste - - -	18	18	—	—	—	18
Turkey - - -	40	11	29	17	-12	28
United Kingdom -	1,239	919	320	30	-290	949
Commodity Reserve	13	13	—	—	—	13
Totals - - -	4,756	3,938	818	818	±565	4,756

Source: 19th Annual Report of BIS, p. 201.

This First Intra-European Payments Scheme was a more elaborate affair than the Multilateral Compensation arrangements which had preceded it. It was woven into the ECA plan for the allocation of Marshall Aid to Western Europe and all of the nineteen OEEC countries participated.¹ The arrangements for monthly clearings by the BIS; for automatic first category compensations

¹ Switzerland and Portugal signed the Agreement, but, since they did not receive aid, they did not participate in the automatic clearing arrangements. Any compensation involving these countries could only take place with their consent.

and optional second category compensations were all embodied in the new agreement.¹ The main innovation was the system of drawing rights and the linking of these with aid under the Marshall Plan. Under ERP, dollar allocation was made to cover the estimated deficit of the participant country with the dollar area, but in addition there was a sub-allocation of dollars to cover estimated intra-European deficits as created by the bilateral payments agreements. Each country then received dollar aid proportional to its dollar deficit and, according to its European position, it either gave or received indirect aid in the form of drawing rights in Europe. The combination of dollar area deficits and intra-European surpluses and deficits could then be taken as a measure of the probable overall deficits. The agreed estimates for aid and drawing rights are shown in Table IX.

The dollar aid granted to European countries to cover the drawing rights of the payments scheme was styled 'conditional aid', the condition being that countries receiving such aid should 'place an equivalent amount of their national currency at the disposal of their debtors on current account of the balance of payments'. . . . 'Thus conditional aid was a basic element of the plan and the creditors were not required to make available more of their currency than was covered by ECA "firm allotments of conditional aid"'.² In practice the aid proved to be unconditional. Countries extending drawing rights which were not utilised did not have their aid reduced and the unused drawing rights were either cancelled or embodied in a later scheme.

Table X shows the drawing rights finally established for the year 1948-49. All countries except Greece gave drawing rights in favour of at least three other countries. From the table three main features emerge: the heavy debtor position of France, who got nearly forty per cent of all the drawing rights granted; the large British credit to France;³ and the heavy creditor position of Belgium and her distribution of drawing rights to ten countries.

¹ It will be recollected that under the Multilateral Compensation Agreement only four so-called 'permanent' members accepted automatic first category compensations while the other participants had the right to reject suggested compensations. The new agreement made operations more automatic in that all countries had to accept all first category compensations. For an excellent account of the technical aspects of the compensations see *19th Annual Report of BIS*, pp. 206-10.

² Cf. *19th Annual Report of BIS*, p. 202.

³ Equal to some 60 per cent of Britain's extended drawing rights.

In operation the 1948-49 Agreement showed similar defects to its predecessor. The volume of clearings continued small. During the first three months operations there were no second category com-

TABLE X

*Intra-European Payments Scheme: Drawing Rights Established
(granted and received)*

Amounts established for year July 1, 1948 to June 30, 1949

Recipient countries	Countries granting drawing rights												
	Austria	Belgium	Denmark	France	Germany		Italy	Netherlands	Norway	Sweden	Turkey	United Kingdom	Totals
					Bizone	Fr. Zone							
in millions of dollars													
Austria - - -	—	4.5	0.1	2.0	32.0	0.5	—	1.0	1.5	—	—	25.0	66.6
Belgium - - -	—	—	—	—	—	—	11.0	—	—	—	—	—	11.0
Denmark - - -	—	6.5	—	2.7	1.0	0.2	—	—	—	—	1.5	—	11.9
France - - -	—	40.0	—	—	63.0	14.0	11.0	—	5.0	—	—	200.0	333.0
Germany:	—	—	—	—	—	—	—	—	—	—	—	—	—
Bizone - - -	—	17.0	—	—	—	—	10.1	—	8.0	5.0	12.0	46.5	98.6
French Zone - - -	—	4.0	—	—	—	—	2.6	2.0	—	1.5	5.5	—	15.6
Greece - - -	0.4	13.0	2.0	5.0	4.3	0.1	7.0	5.0	2.0	5.0	13.0	10.0	66.8
Italy - - -	2.0	—	—	—	—	—	—	—	—	—	—	25.0	27.0
Netherlands - - -	—	72.5	—	—	8.5	—	—	—	—	2.0	—	—	83.0
Norway - - -	—	23.0	—	—	—	—	0.5	2.5	—	21.8	0.5	—	48.3
Sweden - - -	0.7	6.0	3.0	—	—	—	0.1	—	—	—	—	—	9.8
Turkey - - -	—	2.0	—	—	—	—	5.0	0.8	—	1.0	—	8.0	16.8
United Kingdom - - -	—	30.0	—	—	—	—	—	—	—	—	—	—	30.0
Totals - - -	3.1	218.5	5.1	0.7	108.8	14.8	47.3	11.3	16.5	34.8	28.5	320.0	818.4

Note: Six of the nineteen signatory countries are missing from the table above. Portugal and Switzerland did not receive ERP aid and did not take part in the European system of drawing rights; Luxembourg is included with Belgium, and Ireland and Iceland, being members of the Sterling Area, are covered by the figures for the United Kingdom; Trieste did not take part in the European scheme. The figures in the table are taken from Annex C of the Agreement of October 16, 1948 with the addition of \$8 million, the drawing right given by the United Kingdom to Turkey according to an agreement made between the two countries on January 25, 1949.

pensations and only \$3.2 mln during the second quarter. Total first category compensations for the nine months ended June 30, 1949 were \$104 mln.¹ The fact that certain countries were persistent debtors or creditors of the group made it difficult to clear debts through compensations and only about ten per cent of net monthly debts were so cleared during the lifetime of the agreement. Once more it proved difficult to arrange second category compensations because of the objections of countries involved. At the end of June 1949, at the close of the last clearing, \$128.5 mln (i.e., about 15 per cent of total) of drawing rights were still unused.² As for individual countries, the difficulties of estimating bilateral

¹ Cf. *20th Annual Report of BIS*, p. 226.

² These consisted mainly of \$86 mln granted by Britain to France, Germany and Italy.

deficits in advance revealed themselves. Many countries had to adjust their import controls in order to make deficits run according to plan, while others probably drew needlessly on their drawing rights simply because they were available. France quickly exhausted her drawing rights with Belgium and suspended imports from that country for three months. Norway had similar difficulties. Both France and Sweden were forced to curtail imports from Switzerland.

The Agreement was of an interim character. It was regarded by OEEC and ECA as providing a breathing-space during which the basic causes of European payments disequilibrium could be eradicated. Yet even as an interim measure it had serious defects. Based on arrangements which were bilateral it allowed little progress towards multilateral trade in Europe. The drawing rights were not transferable and, once settled, they dictated the channels in which trade had to flow. Moreover, since they were based on forecasts, they were liable to error or to the perversions of national self-interest. Yet none of these defects was so serious as the fact that the scheme provided no incentive to deficit countries to correct their deficits. Countries were content to take advantage of their drawing rights and to trim their trade to conform to them. Since it was rumoured that next year's drawing rights were to be determined by this year's deficit there seemed to be no reason to reduce the deficit. Although the external disequilibria which existed between European countries at this period were fundamental and it would have been useless to seek for any automatic corrective force within the scheme, there was still every reason that members should be encouraged to work for external balance. Ingenious as the scheme was in conception, there can be no doubt that this lack of a corrective incentive was a serious defect.

Yet, on balance, the effects of the Agreement were beneficial. During 1948 and 1949 intra-European trade was expanding rapidly and, although several factors were at work, it is probable that easier payments conditions contributed to this expansion. The scheme made it easier for European countries to import primary commodities from the Sterling Area with commensurate dollar saving. Finally, with the greater payments freedom, a number of countries were able to conclude trade agreements which were beneficial both to themselves and to European trade generally.

The shortcomings of the First Intra-European Payments Agree-

ment required alterations when the Agreement fell due for renewal in July 1949. The First Agreement expired at the end of June and there was then an interregnum until the second was signed on September 7. During these two months the compensation arrangements of the old Agreement were continued but no drawing rights were available. It was agreed, however, that participating countries should grant temporary credit where necessary to cover the period.

The negotiations which preceded the signing of the new agreement were long, heated and at times almost acrimonious. ECA suggested that, in order to give greater flexibility to payments and to stimulate competition, drawing rights should be transferable between OEEC countries and might even have limited convertibility into dollars. Thus, if Germany had drawing rights on France but wished to buy in the United Kingdom, it should be allowed to use its French francs for this purpose. Unfortunately such transfers might have detrimental effects. If, for example, the United Kingdom's holding of French francs were to be raised to the level at which the Franco-British bilateral agreement required France to convert Britain's surplus francs into gold or dollars then the transfer would redound to France's disadvantage. It was quickly perceived that situations such as this were likely to arise. Belgium, as a chronic creditor country, was likely to find herself holding excess balances of many other currencies, and several countries, among them the United Kingdom, saw a threat to their gold and dollar reserves. The negotiating parties were quickly split into two groups: the United Kingdom and the Scandinavian countries opposed the scheme,¹ while France and Belgium were anxious for its adoption. This divergence ran through several barren conferences and a fruitless session of the OEEC Council. At one stage it bade fair to wreck OEEC, but a compromise was reached on July 1, when it was agreed to transfer only up to 25 per cent of the drawing rights and to make special arrangements to deal with the problem of the Belgian surplus.

The Revised Agreement² was similar to its predecessor save that it was longer and provided for four new groups of provisions: those which related to transferable drawing rights; those which were in-

¹ In considering Britain's attitude it is well to remember the date — the summer of 1949, when the Sterling Area gold and dollar reserves were undergoing the contraction which preceded devaluation.

² For text of the Agreement see *20th Annual Report of BIS*, 1950, pp. 263-93.

serted to make the agreement more flexible; those designed to deal with the creditor position of Belgium; and those which were designed to meet the criticism of 'wrong incentives' which had been made of its predecessor.

The allocation of drawing rights was still determined by bilateral negotiations between the OEEC countries.¹ Once the drawing rights were settled each individual drawing right was reduced by 25 per cent and the sum of the reductions placed in a pool of multilateral drawing rights. Thus each country found itself with a specific bilateral drawing right on certain other countries, and an additional drawing right which could be used to cover deficits in any OEEC country. Drawing rights could only be used by a country after it had used all its reserves of the creditor's currency. Bilateral drawing rights were to be used automatically and the same applied to multilateral rights save (a) where multilateral drawing rights were to be used by a debtor to pay a country which had not established bilateral drawing rights in its favour, or (b) if the multilateral drawing rights being used to pay a creditor exceeded during one year a third of the bilateral drawing rights which the creditor was extending to the debtor. In either of these cases the BIS could act only at the request of the debtor. The multilateral drawing rights established under the Agreement totalled \$172.4 mln while those used came to \$153.2 mln. Of these \$90.3 mln was used automatically while the balance, \$62.9 mln, was used under the transferability provisions. Thus not much more than a third of the multilateral drawing rights were used outside the bilateral arrangements. The BIS thought that, while multilateral drawing rights gave some increase in flexibility, their influence was not, in fact, very great.

Other provisions were embodied by which it was hoped to make the working of the Agreement more flexible. It was, for example, intended that the OEEC should carry out comprehensive reviews of the working of the payments scheme at least twice during the year ended June 30, 1950. One of the main purposes of such reviews was to see that countries did not get dollars from the multilateral pool of drawing rights by curtailing their imports. It was understood that the reviews would be searching and that if defects

¹ Total drawing rights amounted to \$784.3 mln. The largest recipients of drawing rights were France, Holland and Greece who received 50 per cent of all drawing rights granted. Britain, Belgium and Germany were to establish the largest amounts of drawing rights.

in the working of the Agreement were revealed they would be quickly met. Another noteworthy provision was that for the revision of drawing rights. Revision became necessary almost as soon as the agreement had been signed. The devaluation of sterling in September 1949 changed the dollar value of all drawing rights while those of some countries changed more than others according to the degree of devaluation. OEEC made several revisions the net effect of which was to reduce bilateral drawing rights by \$85.5 mln and redistribute \$67.4 mln in bilateral and multilateral drawing rights.

The Second Intra-European Payments Agreement was superior to the first in that a real attempt was made to meet the problem of the Belgian export surplus. During the year ended June 30, 1950 Belgium's surplus with the other OEEC countries was estimated at \$400 mln, whereas Belgium's dollar deficit was deemed to deserve \$200 mln in aid. It was evident that, even if Belgium were to grant drawing rights to the full amount of its dollar aid, this would only finance half of its European surplus. The uncovered part of the surplus would arise from exports to France, Holland and the United Kingdom. Although these three countries were to get 60 per cent of the original drawing rights (\$120 mln) this would not be sufficient. So a solution was sought through three sets of measures: firstly, Belgium was to lend France \$21.5 mln, Holland \$38 mln and the United Kingdom \$28 mln, these credits thus covering \$87.5 mln of the expected deficit; secondly, the remaining \$112.5 mln was to be met by additional drawing rights in favour of France, Holland and the United Kingdom, made on the condition that the United States would increase Belgium's aid by an equivalent amount; and thirdly, it was agreed that total drawing rights against Belgium by all other OEEC countries should not exceed \$352.5 mln.

In the event these measures proved unnecessary. Instead of providing aid of \$440 mln to OEEC countries, Belgium had only to give \$278 mln, — Holland being the only country to use its drawing rights fully.

The efforts made to meet the criticism of 'wrong incentives' are hard to assess. The influences at work in Europe during 1949-50 were such as to promote greater external stability and a reduction of deficits. From the effects of devaluation, French and German recovery and other forces it is impossible to disentangle the effects

of whatever incentives the Agreement provided. In order to meet the critics' demands it was provided under the new agreement that a creditor might complain to OEEC if excessive use was made by its debtors of their drawing rights. Debtors, on their side, might complain if any action by a member seemed calculated to increase or prolong their deficit. In addition to these provisions there were a number of minor measures for making European trade more competitive. All in all, however, it can hardly be claimed that such provisions as these did much to provide incentives to countries to bring their balances to equilibrium.

The Second Intra-European Payments Agreement was an advance upon its predecessor. More trade was financed by its drawing rights and more compensations were effected, but whether this was the result of the Agreement or of an improvement in European trade cannot be sure. There was, in late 1949 and early 1950, a great improvement in the European economic situation. The external accounts of France and of the United Kingdom improved and, although Holland and Western Germany were still debtors, it was evident that the economic weather was changing. While it is not possible to ascribe this change entirely to the two payments agreements it is likely that they contributed to it.¹ But the wisdom of pushing forward with further co-operative schemes based on drawing rights was doubtful. Expanding trade required a wider multilateral basis and it was in search of this that further efforts were directed. The result of these efforts was the European Payments Union, perhaps the most successful experiment in international monetary co-operation which has yet been made.

II

Immediately the Second Intra-European Payments Agreement had been signed energies were directed to finding a means whereby European trade and payments could be made fully multilateral. The initiative in the negotiations came from ECA and was derived from the American pressure for European political and economic union. In December 1949, ECA submitted a plan to

¹ During the twenty-one months during which the two payments schemes were in operation the \$1,380 mln of drawing rights, corresponding to an equivalent amount of conditional aid, covered approximately a third of gross intra-European deficits — the remainder being met by gold movements, bilateral credit and the drawing down of bilateral balances. Only 2 per cent were compensated.

OEEC which aimed at the creation of a central clearing union for European payments, and in which debits and credits of the participating countries would be offset one against another to leave each country the debtor or creditor of the Union as a whole. After swift initial progress the negotiations once more revealed divergent national views and proceeded very slowly. Britain was a notable sceptic. She had received in 1949 a salutary lesson in the effect which a minor recession in the United States could have upon her foreign balance and international reserves, and, although in 1950 her balance of payments was improving, the British government was nervous of any scheme which might result in claims upon the reserves of the Sterling Area. The payments union proposal seemed to imply just such a threat. If the free convertibility of the pound within the Sterling Area were to be linked with the automatic European convertibility of the proposed Union, sterling might flow from the Overseas Sterling Area to OEEC countries and result in dollar claims. These fears led to protracted negotiations and the British did not agree to participate in the proposed Union until May 1950.

Belgium also proved recalcitrant. She wanted to earn dollars from the Union and was apprehensive of the inflationary effect upon her economy of large European credits unmatched by dollar imports. At one stage of the negotiations the Belgian cabinet rejected the agreement completely and only hard bargaining and some concessions regained their support. On July 7, 1950 the Council of OEEC agreed on the terms of the Union and the European Payments Union Agreement was formally signed on September 19, 1950.¹

The EPU came into operation from July 1, 1950.² It differed radically from the first and second payments agreements in that it provided a system of multilateral settlements. Where the earlier arrangements had left, after possible compensations had been made, a network of separate debts between individual European countries, the EPU ensures that, at each settlement, any given country finds itself in credit or debit with the Union. Thus

¹ Cf. *Documents Relating to the European Payments Union*. Issued by OEEC and published in Britain by HMSO, 1950. See also 'The Mechanics of EPU'. *The Economist*, July 15, 1950, pp. 130-2.

² Although the Agreement was signed in September it was retroactive to July 1. The first accounting period was from July 1, 1950 to September 30, 1950. Thereafter operations were conducted on a monthly basis.

the offsetting mechanism of the Union allows surpluses earned in one country to cancel deficits incurred in others. It allows freer trade within the group, and it makes it unnecessary for any country which is in balance with the group to discriminate against the exports of any single member with whom it may be in deficit. The periodic settlement of each country with the Union is concluded according to an agreed formula — part in credit and part in gold — the arrangements having no effect upon the actions of individual traders, taking place through national central banks. The participant central banks extend to one another such credit as is necessary to maintain normal trade and each month the net cumulative position of each country relative to the Union is computed by the BIS, which acts as agent for the Union. The credit or debit position of the member is carried forward as a cumulative monthly position — a limit being set to this debit or credit by the 'quota' of the country concerned. These quotas were allotted to each member country when the Union was established and were settled at 15 per cent of the member's visible and invisible trade with all other members in 1949.¹ (Cf. Table XIII, col. 1.) They mark the limits for each country of the cumulative accounting surplus or deficit which may be dealt with normally through the Union by credit or gold payments without resort to special arrangements.

Settlement between a member and the Union is made at the end of each month. For the purposes of this settlement the cumulative trading surplus or deficit of the member with the Union is subject to certain adjustments: the initial position; the use of special resources; and the use of existing resources. These adjustments will be dealt with later. Once they are made the 'accounting position' of the member relative to the Union is determined. The month's change in this accounting position, debtor or creditor, is the basis of the monthly settlement which, during the lifetime of the Union, has been made in two ways. From the beginning of operations in July 1950 until June 1954 the form in which settlement took place (i.e. part in gold and part in credit) was determined by the cumulative position of the country (expressed as a percentage tranche of its quota) relative to the Union. At each settlement a debtor of the Union received credit from the Union and/or made payments of gold to the Union in a specified ratio; any creditor of the Union

¹ They have been revised twice: in June 1954 when they were raised by 20 per cent and in August 1955 when they were doubled.

gave credit to the Union and/or received payment of gold from the Union in a specified ratio — the ratio being determined in both cases by the size of the cumulative position. As from June 1954 the system was simplified, the tranches within the quota being abolished and all debts to or from the Union being settled on a fifty/fifty gold and credit basis. This was revised to 75 per cent gold and 25 per cent credit in August 1955.¹ In order to preserve at a constant absolute amount the credit element (averaging 60 per cent) contained in the original quotas, the quotas have been increased with each revision of the gold/credit settlement ratio. For example, Norway whose quota was originally 200 units (with an average credit element of 120) had its quota increased to 240 units when the ratio for settlement was revised to 50 per cent gold and 50 per cent credit, and to 480 units when the ratio became 75 per cent gold and 25 per cent credit. The various systems of settlement and the specified ratios of gold and credit since the start of the Union are summarised in Table XI.

The basic principle of EPU should now be clear. The Union works upon the overdraft principle, member countries extending to the Union limited overdraft facilities in their currencies and receiving in return overdraft rights. Countries in deficit with the Union settle partly by adding to the overdraft and partly in gold or dollars. The Union settles with its creditors, in the same way. For deficit countries, EPU facilities are granted automatically up to the amount of the member's quota but once the deficit exceeds this allowed basic overdraft the country incurs a 100 per cent settlement in gold or dollars which acts as a penalty and provides increasing incentive to eliminate the deficit.

The Union is, therefore, largely self-balancing, since its credits to and receipts from some members will be balanced by the debit position of others. Since, however, the Union in its early years might in certain circumstances have had to pay out more gold

¹ One of the merits of the EPU settlement mechanism is that it can be made 'hard' or 'soft' as occasion demands by changing the ratio of gold to credit. If settlement were to be made 100 per cent in gold this would be tantamount to a form of complete convertibility of European currencies. The initial aim was to fix the scale for settlement so as to deter members from tolerating a deficit while at the same time not making it so hard as to encourage them to raise trade barriers. Subsequent revisions have made the settlement progressively harder. One reason for the increase in the gold proportion of the settlement in June 1952 was to safeguard the solvency of the Union whose resources were threatened by surpluses being concentrated in a few creditor countries.

TABLE XI

Methods of Settlement with EPU

The methods of settlement have been applied as follows:

- (a) from July 1950 to June 1952; (b) from June 1952 to June 1954;
(c) from June 1954 to July 31, 1955; and (d) from August 1, 1955.

(a) and (b). Specified ratios of gold and credit, the gold element increasing progressively for debtors with the use of the quota.

<i>Tranches</i>	<i>Creditors</i>		<i>Debtors</i>			
	<i>(a) and (b)</i>		<i>(a)</i>		<i>(b)</i>	
	<i>Percentage of tranche settled in</i>		<i>schedule</i>		<i>schedule</i>	
	<i>credit</i>	<i>gold</i>	<i>credit</i>	<i>gold</i>	<i>credit</i>	<i>gold</i>
1st 20 per cent -	100	—	100	—	(a) 100 (b) 80*	(a) — (b) 20*
2nd 20 per cent -	50	50	80	20	70	30
3rd 20 per cent -	50	50	60	40	60	40
4th 20 per cent -	50	50	40	60	50	50
5th 20 per cent -	50	50	20	80	30	70

* The first tranche was divided into two equal parts (each 10 per cent of the quota) known as 1(a) and 1(b) respectively. The complete first tranche had an 'overall' ratio of 90 : 10 credit and gold.

(c) As from June 1954 the tranches within the quotas were abolished and all debts to or from the Union were to be settled on a fifty/fifty gold/credit basis. Beyond the quota debtors were to pay one hundred per cent in gold, save where special borrowing facilities were available.

(d) As from August 1, 1955 the settlement basis was further hardened to 75 per cent in gold and 25 per cent in credit.

Under schemes (a) and (b) the quotas contained an average credit element of 60 per cent. This was preserved in scheme (c) by increasing quotas by 20 per cent with the increase in charges and in scheme (d) by doubling the quotas.

than it was receiving¹ the United States Government provided, through ECA, liquid resources of up to \$350 mln. This was done partly to meet the establishment of initial positions (see below) and partly to ensure the gold and dollar solvency of the Union.

In computing a country's debtor or creditor position relative to EPU a cumulative system is used. Prior to June 1954 this ensured

¹ The circumstances in which the Union's payments outwards of gold might have exceeded its payments inwards were two, prior to 1954: (a) creditors of the Union were paid in gold at the rate of 50 per cent after the first 20 per cent of their quotas, whereas debtors did not have to pay so much gold at first, and only after they had paid 60 per cent of their quota did their gold payments to the Union exceed the credits they received; (b) when EPU had numerous small debtors and a few large creditors.

that a country with a rising deficit was forced to make, at each settlement, an increasing proportion of the payment to the Union in gold. But it has the further advantage that a country which has been running a deficit with EPU and losing gold can start to recover that gold by a single month's surplus with the Union, although cumulatively it is still in deficit.¹ Table XII shows by a series of examples the way in which the pre-1954 system of settlement operated.

TABLE XII
Settlement with EPU of Country X
Quota of X-150

	Surplus (+) or deficit (-) for the month	Cumulative position at end of period	Means of Settlement	
			(a) Under original scheme at July 1950	(b) Under present scheme
<i>When X is a surplus country</i>				
Period I	+30	+30	Gives credit of 30 to EPU.	Gives credit of 7½ to EPU. Receives gold payment of 22½ from EPU.
Period II	+30	+60	Gives credit of 15 to EPU. Receives gold payment of 15.	Gives credit of 7½ to EPU. Receives gold payment of 22½ from EPU.
Period III	+10	+70	Gives a credit of 5 to EPU. Receives gold payment of 5.	Gives credit of 2½ to EPU. Receives gold payment of 7½ from EPU.
Period IV	-20	+50	Reduces credit to EPU by 10. Makes gold payment of 10 to EPU.	Reduces credit with EPU by 5. Pays 15 in gold to EPU.
<i>When X is a deficit country</i>				
Period I	-30	-30	Receives credit of 30 from EPU.	Receives credit of 7½ from EPU. Pays 22½ in gold to EPU.
Period II	-30	-60	Receives credit of 24 from EPU. Pays 6 in gold to EPU.	Receives credit of 7½ from EPU. Pays 22½ in gold to EPU.
Period III	-30	-90	Receives credit of 18 from EPU. Pays 12 in gold to EPU.	Receives credit of 7½ from EPU. Pays 22½ in gold to EPU.
Period IV	+20	-70	Reduces debt with EPU by 12. Receives gold payment of 8.	Gives credit of 5 to EPU. Receives gold payment of 15 from EPU.

In order to obtain a member's 'accounting position' with the EPU in any period the cumulative surplus or deficit of the member with the Union is subject to certain adjustments. The first of these is the item 'existing resources'. These resources con-

¹ Compare this with the position under ordinary bilateral settlements. If A has reached the limit of its swing with B and is making payment in gold it will have to correct imbalance and then build up a cumulative balance with B in excess of B's swing before gold begins to flow back to it. This may take a long time.

sisted of the debts of members outstanding on June 30, 1950 on current account, and held by other members. Such pre-existing debts had been a major worry of the United Kingdom who feared that if the OEEC-held sterling balances were thrown into the EPU clearing the United Kingdom would lose gold. A number of other debtor countries held similar views. Some creditor nations, notably Belgium and Switzerland, were, on the other hand, anxious to include provision in the Union for the clearing of pre-existing debts. Eventually, it was agreed that, in the absence of a bilateral agreement to amortise the balance of an outstanding debt it could be held by the creditor as 'existing resources' for settling any net deficit with the Union. A balance which was classed as existing resources was thus equivalent to an initial creditor position for the holder and to an initial debtor position for the country against whom the debt was outstanding. Britain, executing a swift *volte face*,¹ agreed to the inclusion of sterling balances held by Sweden, Portugal, France, and Italy in the EPU clearing.

Although the drawing rights of the earlier payments schemes did not survive in EPU they were vestigial in the system of 'initial positions'. The cumulative reckoning of debtor and creditor positions did not start from zero. Six countries were given initial creditor positions and three initial debtor positions. Thus the creditors could draw upon EPU to the extent of their positive balances before they began to draw upon their quotas, while the debtors were virtually required to give away goods and services until their initial debits were exhausted. These initial debit positions were, however, offset by conditional American aid, and their total was almost the same as the total drawing rights under the previous scheme. Nevertheless, the positions were not regarded as drawing rights, but as adjustments necessitated by the conditions of 1950/51 which would enable EPU to operate smoothly in its early stages. It was regarded as essential that there should be no chronic debtor or creditor countries in the Union and as some countries

¹ The change of front was probably due (a) to the swiftly improving British balance of payments, and (b) to ECA's promise to make good any losses of gold or dollars that Britain suffered as a result of allowing OEEC countries to use their balances. In a letter on July 7, 1950 the American government agreed to recoup the United Kingdom for any loss of gold or dollars so incurred. Up to the end of June 1952, when this agreement ended, sterling had been used as existing resources to the value of \$100.1 mln. This of course increased the British deficit and necessitated a gold payment of \$96.9 mln to the Union. During the 1951 calendar year the American government paid to the British government \$40 mln in recoupment and during 1952 payments totalling a further \$52 mln were made.

would clearly find it difficult to balance their accounts with other OEEC countries, it was hoped that the initial positions would offset such imbalance. The initial positions are shown in column 4 of Table XIII.

In the second year of the Union the technique of grants in the form of initial balances was not retained. In its place a method of giving American aid to the persistent debtors was established in the system of 'Special Resources'. Under this system dollars were allotted by the United States government on behalf of certain debtors directly to the Union itself. Thus, not only were the payments positions of the debtors made more favourable but the system was a valuable source of dollars for the Union. Like the 'existing resources' the 'special resources' were not subject to the cumulative principle. For example if Greece had a net surplus in any month it did not receive back the dollars paid by it for previous deficits under the special resources scheme. Instead it granted credit to the Union which thus was able to retain the dollars which it had acquired.

These three adjustments, (i.e. existing resources, initial positions, and special resources) formed, until June 1954, the total adjustment made to the cumulative surplus or deficit of a country in order to ascertain its cumulative accounting position; they were shown in the annual returns of EPU under three columns entitled Ante-Quota Settlements. As from 1954, however, certain other Ante-Quota adjustments appear in the return. The three adjustments mentioned above are now shown compositely in one column only (see Table XIV) while in a second appear the various adjustments due to the repayments of credit by certain members and by the Union following its renewal in 1954. Finally, an adjustment must be made to the French position as a result of gold paid by France to cover deficits outside her quota up to June 1954 and now recoverable by that country under a later agreement. All these adjustments are grouped in columns 1, 2 and 3 of Table XIV. The remaining four columns show how the accounting position with the Union was then settled.

The provision whereby (prior to 1954) debtors were required to settle their account with the Union in accordance with a sliding scale which provided for proportionally increasing gold payments acted as an incentive to debtors to take direct domestic action to deal with their OEEC deficit. In order to reinforce this incentive

apply for aid from a special assistance fund administered by ECA. This is a two-edged weapon, however, since its effect would be to give ECA the right to demand whatever correctionary policies it deemed appropriate.

The arrangements to meet a chronic credit balance are also reminiscent of the IMF. Once a creditor's surplus passes 75 per cent of its quota OEEC must consider what action is appropriate to the restoration of balance. Two possibilities present themselves: the creditor's quota may be enlarged or other members may be permitted to discriminate against imports from the creditor. In the last resort the member may withdraw from the Union once its quota is exhausted.

The terms for special assistance and the arrangements for OEEC to recommend policies to member countries were symptomatic of the ECA view that EPU should be operated by a strong board with considerable power over members. Such a view had been pressed by the Americans but the OEEC countries were suspicious of any interference with national economic sovereignty and the system of management finally set up is innocuous enough. The Union operates within the framework of OEEC and, under the authority of the Council of that body, is governed by a Managing Board, which is made up of not more than seven members 'appointed by the Council from persons nominated by the Contracting Parties'.¹ The powers of the Board are not precisely defined in the Agreement, but it is responsible for supervising the execution of the Agreement, and is subordinate to the Council of OEEC which can delegate powers to it. Unlike the governing authority of the IMF the Managing Board of the Union is non-political, being, in fact just that small and expert group which Keynes had hoped would lead the Fund. There is every indication that the Board has worked well and its decisions have been unclouded by any tinge of political bias or doctrinaire belief.²

The initial agreement provided for the EPU to operate at least until June 30, 1952 after which it was to be liquidated if members

¹ The first Board had an Italian chairman, French and British vice-chairmen, and Dutch, Danish, German and Swiss members. A representative of ECA sits on the Board as observer but does not vote.

² Robert Marjolin, Secretary General of OEEC said of the Board: 'The existence of a small group of highly qualified individuals, each holding a position of importance at home but willing to devote up to a week each month in discussing the business of the community, is an invaluable adjunct to any international system.' Cf. 'The European Trade and Payments System', *Lloyds Bank Review*, January 1954, p. 13.

whose quotas totalled more than 50 per cent of the aggregate were to withdraw from it. It was, in fact, intended to operate 'until it is possible to establish, by other methods, a multilateral system of European payments'. On the unanimous decision of members it was renewed for one year, i.e., up to June 30, 1953. Since that time, it has been renewed each year, and is at present scheduled to remain in being until June 30, 1957.

Meanwhile certain changes were made in the mechanism of EPU, largely to adapt it to changing circumstances¹ and make it still more effective in the period of waiting for convertibility. When, in June 1954, the Union was renewed for a further year the following important changes were made in its working.

(i) Five debtors to the Union — Denmark, France, Italy, Norway and the United Kingdom — agreed voluntarily with seven of the Union's creditors to deal bilaterally with debts which otherwise would appear on the liquidation of the Union. As a result thirty-three agreements were made and provide for the progressive settlement of \$863 mln of debts outside the Union — each payment when made cancelling an equal amount of the debtor's debt to, and the creditor's claims on, the Union. This was done to reduce the total amount of credit extended within the Union.

(ii) The Union itself repaid in dollars in July 1954, \$130 mln of credit granted to it by creditors — \$100 mln divided amongst creditors proportionately to their credits at April 30, 1954 and a further repayment of \$30 mln to Germany to reduce its extreme creditor position.

(iii) For the future the Union was to operate on a fifty-fifty gold and credit basis for all normal operations. As this would have the effect of reducing the former credit element of 60 per cent it was decided to increase quotas by 20 per cent in order that there should be no reduction in the amount of credit available to each country. The tranches within the quotas were abolished. Above the quotas, creditors might grant further credit up to agreed 'rallonges', debtors paying 100 per cent in gold for settlements beyond the quota save when borrowing was available as rallonges. The settlement basis was revised again in August 1955 when the gold/credit ratio was increased to 75 : 25 and, to retain the credit element in the quota, the existing quotas were doubled.

¹ In particular the diminished margins of credit facilities remaining available to cover further deficits.

(iv) In return for the repayment of part of their claims upon the Union (as provided for in (i) above) creditor countries agreed to accept new and higher levels for the credits which they might grant to the Union outside the quota. This system was extended and modified in August, 1955.

(v) A parallel arrangement was made for debtors who entered into bilateral agreements for repayment before December 31, 1954. Credit facilities were reopened for such debtors (a) within the quotas by amounts equivalent to the individual cash repayments, and (b) by a share of \$160 mln in the form of *rallonges* above the quota.

These alterations gave to the Union a distinctly new look and it was clear from them that the Union was being adapted to the improved condition of the European economy. It has, however, been widely recognised that if convertibility of sterling is achieved the Union, in its present form, will be unable to continue and, in early 1955, the Council of Ministers of OEEC reviewed the future of the Union. After a report by a committee of experts they recommended that, until convertibility, EPU should be renewed year by year, but that when major European currencies become convertible the Union should be wound up and replaced by other co-operative machinery. The nature of such machinery is defined in a new European Monetary Agreement which is to become operative at convertibility. This will be described in due course.

Since it is impossible to deal minutely with the working of EPU since its inception we must be content to summarise its contribution to European payments up to March 31, 1956. Finally we shall touch upon one or two of the problems which EPU has encountered.

Table XIV shows the financial position of the Union in the spring of 1956. This table illustrates the automatic and basically simple nature of the Union's operation. Because of the cumulative nature of the figures it presents a summary history of Union transactions up to that time. In column 1 are shown the cumulative external balances of member countries relative to the Union. After the adjustments of the Ante-quota Settlements the accounting surpluses and deficits of members with the Union (col. 8) were settled partly in credit and partly by gold payments. Cols. 5 and 6 show the amount of the settlement made by credit and by gold payments respectively.

It is also appropriate to note the continued solvency of the Union,

TABLE XIV

*EPU: Cumulative Positions of Member Countries
July 1950 to March 1956*

Member countries	Net positions cumulative surplus (+) or deficit (-) of country	Effect of ante-quota settlements and adjustments			Covered within the Union ⁴			
		Ante-quota settlements and adjustments ¹	General adjustments ²	Gold recoverable (+) from Union by special settlement under Art. 10 bis ³	Credit received (+) or granted (-)	Gold actually paid (+) or received (-)	Gold settlement adjustment ⁵	Total equal to accounting surplus (+) or deficit (-) of country
	1	2	3	4	5	6	7	8
in millions of units of account								
Austria -	- 101	+ 125	- 27	—	{ (- 0) ⁶ - 10 ⁸ }	- 13	- 3	
Belgium -	+ 928	- 306	+ 92	—	+ 178 + 350	+ 185	+ 714	
Denmark -	- 207	- 5	- 176	—	- 97 - 73	- 218	- 388	
France -	- 957	+ 102	+ 198	+ 196	{ (- 35) ⁶ - 81 - 442 }	+ 96	+ 461	
Germany -	+ 1,745	+ 12	+ 488	—	+ 561 + 1,034	+ 650	+ 2,245	
Greece -	- 275	+ 269	—	+ 6	- 35 ⁶	—	—	nil
Iceland -	- 27	+ 15	- 8	—	- 5	- 5	- 11	- 21
Italy -	- 576	+ 43	- 207	—	- 185	- 284	- 271	- 740
Netherlands -	+ 441	+ 30	+ 201	—	+ 168 + 248	+ 256	+ 672	
Norway -	- 285	+ 60	- 233	—	- 115 - 88	- 256	- 458	
Portugal -	- 20	- 3	- 40	—	{ (- 15) ⁶ - 10 }	- 31	- 63	
Sweden -	+ 66	+ 6	- 41	—	+ 8 + 25	+ 1	+ 31	
Switzerland -	+ 314	—	+ 58	—	+ 93 + 172	+ 107	+ 372	
Turkey -	- 366	+ 92	- 70	—	- 30 - 244	- 70	- 344	
United Kingdom -	- 677	- 243	- 462	—	- 345 - 387	- 650	- 1,382	
Cumulative creditors -	+ 3,495	- 235	+ 775	—	+ 1,009	+ 1,840	+ 1,186	+ 4,034
debtors -	- 3,492	+ 431	- 1,001	+ 202	- 859	- 1,589	- 1,413	- 3,860
Net totals -	+ 3	+ 196	- 227	+ 202	+ 150	+ 251	- 227	+ 174 ⁷

¹ Net amounts of existing resources, initial balances (grants and loans) and special resources utilised prior to June 1954 and reduction of cumulative accounting surpluses due to June 1952 adjustments for Belgium and Portugal.

² Arising from the renewal operations as at July 1, 1954, adjustments for opening of business August 1, 1955, and repayments of credit (bilaterally and by the Union).

³ Gold paid by France to cover deficits above the quota up to June 1954 and gold paid by Greece in one hundred per cent settlement of deficits, no longer shown in the cumulative accounting deficits and now recoverable under Article 10 bis of the Agreement.

⁴ Within and outside quotas.

⁵ The gold adjustment is the difference between the cumulative accounting positions and the total of actual settlements, by gold and credit, made through the Union.

⁶ Settled temporarily in gold in accordance with Article 11 (d) of the Agreement.

⁷ The cumulative accounting deficits are lower than the cumulative accounting surpluses by \$174 million, this being the net amount by which the ante- or post-quota settlements by debtors exceeded those of creditors (special resources, \$367 million, plus the net amount of initial balances, \$125 million, the remainder of the amount still recoverable by France and Greece under Article 10 bis of the Agreement, \$202 million, the net interest paid by the Union, \$3 million, less the net adjustments for June 1952, \$296 million, and the amount shown in the column 'General adjustments', \$227 million).

Source: BIS, 26th Annual Report, p. 206.

which, in an accounting sense, operates as a fund. This fund is fed by: (a) an original grant of \$350 mln made by the United States government; (b) the gold and dollar payments of members of the Union; (c) the credits granted by the Union to debtors, and (d) the income accruing from these assets; while the fund is used to : (a) make gold and dollar payments to the Union's creditors; (b) to meet the obligations of the Union for credits granted by creditors; and (c) to cover sundry expenses of the Union. As can be seen from Table XV any fears which might have been held in 1950 as to the solvency of the Union have proved groundless.

TABLE XV
EPU Statement of Account
(Mln of units of account)

<i>Assets</i>				<i>Liabilities</i>	
	<i>June</i>	<i>March</i>		<i>June</i>	<i>March</i>
	1950	1956		1950	1956
Liquid resources -	350	409	Capital ² -	286	272
Grants not yet received ¹ -	215	—	Grants not yet given ³ -	279	—
Credits granted -	—	894	Credits received	—	1,029
	565	1,303		565	1,301

Source: BIS. 26th Annual Report, p. 208.

¹ Initial debit balances not then utilised.

² Difference between initial debt of \$350 mln and credit balances allotted as grants.

³ Initial credit balance not yet utilised.

A word should be said of the special role played by sterling under EPU arrangements, a role made special by the freedom with which sterling moves as a medium of payment outside Europe, in the Sterling and Transferable Account Areas. Two aspects of sterling's position were apparent at the outset: firstly, the inclusion of Britain in the EPU arrangements greatly widened the multi-lateral clearing function of the Union since it provided a link between the OEEC countries and the Sterling and Transferable Account Areas; and secondly, it posed special problems for Britain and the Sterling Area. These problems were three. First, certain West European countries were already members of the Transferable Account group and, in so far as they would now be members of EPU, settlements between them would be in EPU units of

account and not in sterling; second, since Britain was both centre of the Sterling Area and a member of EPU, sterling payments between Sterling Area countries and Union members were similar in effect to payments between EPU and Britain. Britain would, in effect, be responsible to EPU for the deficits of all Sterling Area countries. And third, several European countries held sterling balances which, if not blocked, would have to be liquidated by bilateral agreement between Britain and the holders, thus necessitating the settling of certain intra-European payments outside EPU. Britain was thus placed in a difficult position. While anxious to extend multilateral trade on the basis of sterling, she was, in the interests of the Sterling Area, forced to oppose the most promising arrangements for the extension of multilateral trade which had been mooted since the war. Such fears held by the government threatened to preclude Britain from the Agreement. To British eyes, the co-existence of two great currency groupings seemed to place a strain on whichever proved to be (or was thought to be) the weaker of the two groups. If, for example, sterling should be the weaker, intra-European and other payments would be concluded in EPU units to the detriment of sterling's position as an international currency. If sterling remained inconvertible, while European currencies strengthened to convertibility, the result would be the eclipse of sterling as a European currency and, perhaps, the defection of such members of the Sterling Area as could earn dollars from credit balances in Europe. It seemed, indeed, in 1950, that the more successful EPU was, the more it would threaten sterling's position. No doubt Britain was unduly influenced in early 1950 by her recent balance of payments difficulties and by devaluation. The inducements to earn and hold sterling for use outside Europe were underestimated as were also the recuperative qualities of the British and Sterling Area trade balances. To the British, bilateral agreements seemed a safe means of husbanding their gold and dollar reserves, and, although exposed to adverse criticism for thus becoming supporters of bilateralism against the pan-European ideas of the Americans, they insisted upon the insertion in the final agreement of certain safeguarding arrangements. These were embodied in the famous Ansiaux proposal which took the form of an optional clause in the EPU Agreement allowing members to advance credits to one another under bilateral agreements as an alternative to EPU

credits. The effect of this clause was to allow such EPU countries as had bilateral agreements with Britain to use sterling when it suited them to do so as an alternative to EPU units. Thus the holders of sterling earned in current trade were under no discriminatory pressure to spend such sterling only in the Sterling Area or to hold it as a blocked balance. It could be dealt with under existing sterling arrangements or it could be passed through the EPU clearing. This amounted to a decision to hold sterling or to exchange it for a balance with EPU. Clearly this placed added responsibility on Britain to maintain confidence in sterling and to make it at least as attractive as EPU units. It raised immediately the question of such sterling agreements as provided for blocked balances. These had to go. The position of OEEC-held sterling balances has already been referred to.¹ They were to be included as 'existing resources' in return for an ECA undertaking to make good any losses of gold or dollars which Britain suffered from use of the balances.

The Ansiaux option was originally designed as a concession to Britain in respect of the special position of sterling. In the event it proved to be a concession by rather than to Britain. In the first place it was decreed that sterling and other currencies accumulated by creditors in lieu of EPU units were to count for gold settlements exactly as if they were EPU units. Thus Britain was not to be able to reduce gold payments by persuading her creditors to hold sterling rather than EPU units. In the second place while the option applied equally to other EPU currencies and not solely to sterling, the inducement to members to hold sterling was certainly greater than that for any other currency because of the former's wide area of use in the Sterling and Transferable Account Areas. Thus the option widened the use of sterling rather than protecting it as had been originally intended. All in all the risks and responsibilities in which Britain was involved in joining EPU were considerable.²

There can be no doubt that Britain's participation in EPU has been beneficial, both to Britain and the Union. It has enabled the establishment, in EPU and the Sterling Area, of an area of multi-lateral settlements which in 1951 accounted for some 40 per cent of

¹ Cf. p. 284 above.

² J. A. Sargent analysed the nature of the Ansiaux option in his article, 'EPU and the Future of Sterling Policy', *Oxford Institute of Statistics Bulletin*, November 1950.

the world's commodity trade. If we add to this the Transferable Account countries (not already in EPU), we have a clearing area within which there is substantially multilateral trade, accounting for about 60 per cent of the world's trade. The fact that, since 1950, sterling has been able to maintain its position both in and beside the Union as centre of this system has given evidence of its ability to act as an international currency over a large part of the globe. It is a measure of sterling's strength that we have come to consider the eventual liquidation of the Union, not through sterling's weakness, but through its full convertibility into dollars.¹

Looking back over the five years of EPU's history it is clear that the original conception of a group of countries, moderately homogeneous as to trade and type, making their trade multilateral, while at the same time protecting themselves from the worst effects of dollar shortage, was sound. Regional clearing has shown itself to be a highly successful form of co-operation in a world where structural imbalance persists and in such circumstances we must admit its worth and school ourselves in its techniques. At the same time we must be ever mindful of the fact that, once fundamental balance in the world trading structure is achieved, the necessity for regional clearing must be reviewed and we must consider whether it should give place to world-wide multilateral trade.

The primary condition of a regional payments group is that there should be approximate long-term balance among the nations which form it. Failing this there should at least be a willingness on the part of creditors and debtors to make provision for their condition, either to achieve balance by appropriate domestic action or to extend credit to deficit countries. If any country within the group becomes a persistent creditor of the other members and refuses to grant them credits the group will soon be disrupted. The creditor will probably terminate membership and may be followed in this by those countries not in deficit with it, leaving deficit countries either to form a new group or to seek what relief they can by bilateral means.

A second necessary condition of stability is that all members of the Union should make use of it to clear *both* deficits and surpluses. If, for any reason, a single currency of the group is sought after and

¹ For a good description of the role of sterling in EPU see Albert O. Hirschman, 'The European Payments Union', *Review of Economics and Statistics*, vol. 33, 1951.

withheld from the Union, the latter will soon become a chronic debtor to the scarce currency country and the Union will accumulate only the weaker currencies. This would, of course, occur if any single EPU currency were made convertible into dollars. Other member countries would then seek that currency in order to change it into dollars, thus withholding it from EPU. The convertible currency country would meanwhile be turning into the Union clearing all European currencies earned by it. Whatever was the true balance of payments position of the convertible currency country with EPU it would consistently show a creditor position in the EPU clearing.

Lastly, it is evident that fixed exchange rates are essential within the group. Multilateral clearing of debits and credits would become difficult to the point of impracticability if the rates of exchange and cross-rates between eighteen currencies were constantly in motion.

There have thus always been two threats to the life of EPU: the danger that chronic creditors might grow weary of extending credit to debtors; and the danger that sterling might be made convertible into dollars. The second of these dangers may be dealt with first. If sterling is made convertible it may be hoped that it will be because the dollar shortage has eased and an element of structural balance has been restored to world trade. In such circumstances the *raison d'être* of EPU as a regional clearing group would be at an end and, having considered it to have served us well, we might pronounce its benediction with gratitude and relief.¹ This danger we may in fact discount for it appears only to threaten EPU's old age.

The threat of imbalance within the group has been with EPU since its inception and has provided it with its most awkward problems of which we may single out two for attention: the record of Germany within EPU and the persistent creditor position of Belgium.

When the EPU was formed in 1950 the German economy was being transformed. After the currency reform in 1948 the Federal Government removed direct controls on production and distribution; output and trade in 1949 and 1950 were expanding rapidly.

¹ There is of course the possibility that sterling should be made convertible while a measure of dollar shortage remained for other OEEC countries. In the event of the EPU being terminated smaller members of OEEC might continue to receive dollar aid directly from the United States. They might also receive assistance from the proposed new European Fund. Cf. pp. 301-3 below.

The immediate effect of this expansion was to increase imports without any commensurate increase in exports so that the German trade balance became sharply adverse. At the same time the impact of the Korean War and the primary commodity inflation turned the terms of trade against manufacturing countries and added to Germany's difficulties. All these difficulties were apparent when the EPU negotiations were taking place in the summer of 1950 and Germany tried hard to secure an initial creditor position with the Union. In this she failed. Moreover, she emerged from the EPU settlement with a quota which was clearly inadequate for the volume of trade which she was likely to support.

Between July and October 1950, Germany was rapidly exhausting her quota. Cuts in American aid led her to switch purchases from the dollar area to the Sterling Area and to Europe. Payment for these imports intensified her EPU deficit, which was made worse by the long credit which Germany gave for exports and her quick payment for imports under the threat of a rumoured sterling revaluation. There was also some capital flight from Germany. In spite of a tighter German credit policy and a threat by the government that import licences would only be granted for immediate use, the external situation continued to worsen and the Federal Government appealed to the EPU for help.

EPU's response was to appoint two experts¹ to study the German problem. In their report the experts stated that they regarded the German payments crisis as transient. To meet it they advocated certain domestic measures by the German government, greater fiscal and monetary stringency, and government control of investment. In November 1950 the Federal Government responded by sending a Memorandum to OEEC listing the measures² which it proposed to take. Slender though this document was it must have satisfied OEEC for, in December, EPU granted Germany a special credit of \$120 mln on which she could draw to cover two thirds of her EPU deficit after the exhaustion of her quota — the remaining third of each month's deficit to be paid for in dollars.³

¹ These were Per Jacobsson, then Economic Adviser to the BIS and Alec Cairncross, Professor of Economics at the University of Glasgow, who was then attached to OEEC.

² These consisted of the imposition of a new turnover tax on non-essentials, a further tightening of credit and some minor steps designed to curtail imports and increase exports.

³ OEEC made a request to ECA that Germany should be given extra dollar aid to cover these payments but this was refused.

This was backed up by a request by OEEC to other EPU countries that they should pursue liberal trade policies towards Germany and allow unimpeded entry to imports from Germany as long as the crisis lasted.

These measures achieved little. By February 1951 the additional credit was almost exhausted and import restriction had to be resorted to. After discussions in the OEEC council in April 1951, recommendations were made embodying three elements: domestic measures to adjust the German economy; principles which would govern German import policy up to June 1, 1951; and plans for German import policy after that date. The most interesting of these elements was that concerned with German short-term import policy. A Mediation Group of three independent experts was appointed by the Council to supervise the allocation of German import licences which were to be given in favour of countries which were in debt with EPU. The appointment of this Mediation Group marked a new stage in European economic co-operation. For the first time a country's import policy was being internationally controlled. It is surprising that this system worked, yet it appears to have done so without serious friction. The group mediated and advised. It did not dictate, but its advice appears to have been taken. No precise information is available as to how specific problems were handled. It seems that, without rigidity, the group worked according to general rules which were accepted as equitable.

By the end of March 1951 the tide had turned for Germany. The adverse balance of payments with EPU had been reversed and by May the special credit had been repaid. There had been a rapid increase in exports to supplement the above policy measures and some of the import cuts were restored. In July 1951 a permanent increase was made in the German quota. The following table shows the movement of German payments balances with EPU:

Payments Balance (\$ mln)	1950			
	<i>Jan-Mar</i>	<i>Apr-June</i>	<i>July-Sept</i>	<i>Oct-Dec</i>
	- 130	+ 61	- 177	- 181
	1951			
	- 89	+ 176	+ 167	+ 150

During 1951 Germany moved from a debtor to a creditor position relative to EPU and she has remained a creditor. In August 1956 Germany's cumulative net surplus of \$2,179 mln was

by far the greatest in the Union, equal to 182 per cent of her quota.

The problem of chronic creditor countries has been persistent and special arrangements have proved necessary for a number of countries who have exceeded, or have threatened to exceed, their quotas. Portugal was the first offender and as early as September 1951 she seemed likely to exhaust quickly her quota of \$70 mln, — an active current balance coupled with the flight of capital from other OEEC countries being the cause of the credit position. The Managing Board of EPU disapproved of certain facets of Portugal's domestic policy which seemed to them to contribute to instability. After discussions between the Board and the Portuguese government it was agreed that any surplus up to \$25 mln in excess of Portugal's quota should be financed half in gold and half in credit. This arrangement at first seemed unnecessary as Portugal's surplus temporarily ceased, but a renewed creditor position caused its quota to be exceeded in September 1951 and further special measures were resorted to. Provision was made for a total of \$30 mln in three equal tranches, gold payments falling from 50 to 40 and 30 per cent and the balance being settled in credit. Portugal has remained a creditor of EPU but the special arrangements made have proved adequate.

Another persistent case of a chronic creditor has been that of Belgium whose surplus position had proved a difficulty under the earlier Payments Agreements. This surplus of the Belgian balance of payments with OEEC countries was partly the result of speedy recovery from the war and early ability to supply steel and capital goods to her less fortunate neighbours, and partly the result of stern domestic counter-measures to quell inflation. In spite of Belgian efforts to increase imports from other countries, and other efforts to achieve balance, the Belgian surplus has been almost continuous. Once its initial balance with EPU had been depleted, Belgium's surplus with the Union rose steadily. By June 1951, 70 per cent of the Belgian quota had been used. By July, 85 per cent had gone and in August the quota was exhausted. The problem of Belgium's persistent surplus has since been dealt with by a series of special arrangements which need not be detailed here but which have all involved the giving of credit by Belgium to the Union.¹ The magnitude of the Belgian problem can be gauged from the fact that by

¹ Cf. *22nd Annual Report of BIS*, p. 231; *23rd Annual Report*, p. 191; and *24th Annual Report*, p. 197.

the end of June 1952 Belgium's cumulative accounting surplus was nearly two and a half times the amount of its quota. Thus the credit granted by Belgium outside its quota was more than the amount granted within the quota. Clearly the continuance of such a condition was dependent upon the goodwill of the creditor country. Belgium construed it as being in her interests to accept the special arrangements proposed by the Union but with the emergence of other creditors (such as Germany) she strengthened her demands for the full payment in gold of her surplus.

The emergence of such a group of chronic creditors might well have proved critical for EPU, and indeed in 1954 the position was threatening but the problem has been successfully met in two ways. Firstly, the new provisions introduced in June 1954 provided for substantial repayments to creditors, Belgium receiving 201 units and Germany 294 units under the bilateral agreements; while secondly, the system of *rallonges* or credits granted by certain countries beyond the quota, have provided adequate borrowing facilities. Germany and Belgium remain (spring 1957) the largest creditors of the Union but there seems no likelihood at present that their creditor status will imperil the stability of the Union.

Apart from its elaborate machinery for multilateral settlements within Western Europe, EPU has contributed significantly to the freeing of trade from restrictions. This it has done in three ways. Firstly, the payments machinery of the Union is such that it is a matter of indifference to any member as to which other member of the Union it exports to or imports from. It is the overall balance with the Union which is important. This eliminates discriminatory controls on trade within the Union. Secondly, the liberalisation measures of OEEC, which, since 1949, have been applied to trade between members, have done much to free European trade from quantitative restrictions and it is to be hoped that with the progressive hardening of EPU settlement there will be no tendency for members to fall below the present standards of restriction-free imports from other members. And finally, the discrimination against the imports of the United States which the relatively soft settlement of EPU has implied, has been progressively reduced by the hardenings of the Union settlement which took place in 1954 and 1955. All in all the EPU contribution to trade liberalisation has been considerable.

The EPU was the result of a process of development in monetary

co-operation which had gone on in Western Europe since 1945. Although differing in its technical operation from the Payments Agreements which preceded it, it was, nonetheless, their logical outcome. Without these it would have been impossible to secure the equilibrium within the group which the Union required, or to move away from the constricting influence of bilateral trade. Once these conditions had been established it remained for the Union to provide, through a more elaborate mechanism, additional liquidity for the finance of European trade.

There can be no doubt that the great flexibility of European payments, the growth of intra-European trade, and the mutual recognition of EPU's function which has resulted in members renewing its life from year to year all indicate a measure of success in its operation. Three factors mainly have contributed to this success: the automatic character of the Union's operation, the specific nature of its objectives and the fact that OEEC countries recognised at the outset the advantages which the Union would bring.

In its automaticity the EPU contrasts with the IMF whose working depends upon the discretionary powers of the governing body and in the last resort upon difficult analysis of particular economic situations. With the Union all is known. Every member country knows exactly what, in given circumstances, may be expected from the Union and, since it is concerned only with facilitating and broadening the basis of European payments, it knows also where the limits of the Union's authority lie.¹ But it is essential to realise that the success of the Union is based upon the need and sense of economic self-preservation of the member nations. For the Union is tolerated only as an interim measure. It is a means of liberalising payments among countries whose payments are approximately in balance one with another but all of whom are debtors of another country (or group of countries) outside the group. Once the imbalance between the group and this third country disappears the *raison d'être* of the Union ends, for it can then be replaced by fully multilateral trade. The Union has utility only as long as the dollar problem lasts. If a long-term

¹ Yet at the same time certain important aspects of the Union's operation have been left flexible. For example, nothing was said in the EPU Agreement of the settlement of debits and credits above a country's quota — it being left to the Managing Board and the Council of OEEC to deal with each case which arises on its merits. The Union is thus not committed to any action but is left free to devise action suitable to circumstances.

structural balance in international trade can be achieved, regional clearing arrangements of this type will be superfluous.

EPU has not lacked critics. It has been argued that the whole principle upon which European regional clearing is based rests upon an acceptance of the argument that dollar scarcity is an inevitable feature of the international economy and that the Union is a comfortable retreat, a self-perpetuating soft-currency system, which has served to delay full convertibility in its stronger members and protected its weaker brethren from the harsh disciplines which might have been their salvation. It might have degenerated to this but it has not. It is not, and has never been regarded by its leading members as other than an interim measure. It was inevitable after the failure of the premature convertibility experiment of 1947 that the long road to convertibility should be travelled in stages; that a partial convertibility of currencies among such countries as were in equilibrium one with another was a natural first stage, to be followed by a progressive extension of this system as currencies became stronger. The EPU was looked upon as an institution which would wither away once dollar balance was achieved. As the dollar problem has eased the terms of settlement have been hardened and plans have been laid for institutional machinery suited to a Europe of convertible currencies. Critics of the Union might do well to consider what European payments might have been in its absence — a thicket of bilateral agreements, exchange restrictions and discriminatory practices. Through regional convertibility a gradual but steady approach has been made to full convertibility.

III

It remains to describe briefly the measures which OEEC propose to implement if and when EPU is terminated. These were proposed by the Council of Ministers in June 1955 and agreed to by all members of OEEC.

The OEEC arrangements have the merit that they regard the movement towards convertibility as a continuous process and that, in spite of the halt which has been called on other fronts they admit no break in this advance. They provide for liberalising changes in EPU as long as it endures, for its termination at any time on the demand of countries holding at least 50 per cent of the quotas, and for it to be replaced, if it is terminated by convertibility, by a European Monetary Agreement setting out in detail the payments

arrangements that are to obtain once the European currencies are made convertible. These arrangements are twofold, providing for a multilateral settlement system and for a European Fund which will extend medium term credit to those in need of it. Over and above these arrangements the OEEC code of trade liberalisation will remain to promote the freedom of European trade. It will be open to members to conclude settlements outside the monthly compensation if they so wish and indeed there are certain inducements (embodied in the exchange rates at which settlements within the system will be made) to induce them to use the free market. Thus the free market in exchanges will be fostered while at the same time leaving the slight relief of the short-term credits between monthly settlements to help lame ducks. This will be the limit of credit allowed, however, for under the new scheme settlements will have to be made monthly in gold and dollars. Countries in difficulties will then have to apply for assistance to the European Fund.

OEEC must certainly be congratulated on the ingenuity and spirit of compromise which went to the making of these arrangements. They are flexible yet they provide for most of the foreseeable contingencies. While they simplify the mechanism of EPU they maintain its framework in the clearing mechanism and thus allow of an orderly retreat from convertibility should that be necessary. On the other hand if as time passes the new system becomes progressively durable this clearing mechanism may well wither away as the bulk of settlements come to be made in the ordinary foreign exchange market.

The least satisfactory part of the Agreement is the plan for the Fund. This is to consist of disposable resources of \$600 mln, of which about \$272 mln will be the transferred residual capital of EPU and the remainder will be raised by members' subscriptions.¹ There are two grounds for anxiety. First, it seems questionable whether such a Fund will be large enough for the work which it may have to do.² If it is intended that the Fund shall confine its activities to the dollar relief of countries temporarily embarrassed at the

¹ The United Kingdom will be the largest contributor with \$86.575 mln, France and Germany come next with \$42 mln each.

² In June 1954, just before the funding of part of the outstanding debt, credits granted by EPU amounted to \$1,142 mln. On June 30, 1955 they amounted to \$872.3 mln, thus exceeding the capital of the proposed European Fund by nearly 50 per cent.

monthly clearing then all may be well, but if it is conceived that, in an extreme crisis, the resources of the Fund should be used to maintain the threatened convertibility of one of the major currencies then it would be unequal to any sustained effort. Moreover, since the Fund's loans have the terminable period of two years it will have to be shrewdly administered if overlending is to be avoided. This leads to the second doubt in our minds: the criteria of judgement and conditions upon which loans will be granted. There is to be no question of automatic aid from the Fund, which will consider requests for accommodation in the light of the suppliant country's needs, the nature of its domestic policy and the soundness of its own (i.e. the Fund's) finances. The Fund may even make the grant of credit conditional upon the country concerned following certain specified policies.

The use of this authority will be a ticklish business. It will be desirable on the one hand to dispel any illusion that the Fund loans are to be automatic while on the other providing evidence that member nations may turn to the Fund with confidence that their requests for assistance will not be set aside on purely arbitrary grounds. It should be the object of the Fund to establish in the early years of its working certain fairly recognisable principles which it will apply in the weighing of applications for loans. It is certainly desirable that this aspect of the new Fund's work should be better handled than it has been by the IMF. As for the use of its authority in order to compel countries to follow given policies the new Fund should walk warily and learn from its predecessor whose attempts to dictate policy have met with no success. It is true that in this matter the new Fund will be better placed than was the IMF in that it will have sanctions to apply against recalcitrant members but these sanctions are only strong enough for gentle coercion and not for major trials of strength. The great merit, and no little part of the success of EPU has been that its operations are fully automatic, known and understood. The more one introduces the political element into international organisations the more one imperils their efficiency.

Interesting and workmanlike as these proposals may be it seems probable that much time may elapse before they are implemented. Indeed it seems probable that if convertibility is long delayed then conditions may so have changed as to demand their partial or complete revision.

SECTION IV

'My speech entreats that I may know the let,
Why gentle peace should not expel these
inconveniences.'

SHAKESPEARE *Henry V*

CHAPTER II

THE PATTERN OF WORLD PAYMENTS

I

TWO distinct sets of questions confront us when we consider the problem of equilibrium in international payments. First, there are those problems pertaining to short-term fluctuations of the balance of payments. Such movements may be the result of non-economic forces, such as a crop failure, which impairs the ability of the country to export; or they may be the result of purely economic forces as, for example, a sudden flight of capital from one country to another, or to the working of the business cycle. Whatever be their cause, they are of such character and duration that, in seeking their adjustment, we may take the structure of the world economy, the nature of production, the character of demand, the world distribution of population and such other aspects of the economic environment, as fixed and given so that such counter measures as may be used for their adjustment are, therefore, chosen only in relation to the short-term problem which they must meet. It is with such short-period adjustments in international payments that we have so far been concerned, either as general cases or as problems facing the international institutions in which we are interested. But international equilibrium is subject also to long-period forces whose working may extend over decades and which, while inextricably intermingled and overlaid with short-term events and problems, work out their inexorable will in the background. These we may describe as 'structural' changes, using the word to imply that such changes are large, fundamental and usually irreversible. Thus, they present us with the problem not only of constantly interpreting them and assessing their value, but also they provide an ever-changing background to short-term problems, so that no two problems of short-term adjustment are ever

quite the same, being cast in a different setting. This makes it difficult and dangerous for the makers of international economic policy to place great reliance on theoretical economic models. Most of our model building in international economics necessarily deals with short-term situations and has little to tell us of the working of long-term forces. Even short-term adjustment problems, complicated as they inevitably are by the setting in which they occur, tend to become fit subjects for individual case studies rather than for straightforward applications of theory to policy.

The international economic problem of our own time serves to demonstrate this dilemma. We sought throughout the interwar period to find a means of dealing with international disequilibrium, turning first to a rehabilitated gold standard and then, when that failed, to a system of flexible exchange rates. What was imperfectly realised was that the failure of these systems to achieve adjustment was due only in part to defects in the systems themselves but was more fundamentally the result of basic changes which were then taking place in the nature and structure of the international economy. The same dilemma still confronts us. We have established in the Bretton Woods system an elaborate mechanism to facilitate short-period international adjustment but the working of that system has been confused and undermined by structural changes in the world economy which had their origins long before the war and whose effects are now all too apparent. The emergence of the dollar problem is the greatest single aspect of such structural change. This problem, manifesting itself in a persistent current account surplus by the United States, reflected partly the growing importance of the United States as a supplier of primary commodities to Europe, partly the swift expansion of the United States as an exporter of manufactures, and partly the difficulties which Europe had in selling its exports to the highly protected and well-stocked American market. In the pre-war economy this European dollar deficit was absorbed by a multilateral system of trade and payments, but this system perished in 1939 and the dollar problem has been complicated and intensified by the war and its economic aftermath. Since 1945 it has presented us with a set of forces which have twisted and distorted the flimsy framework which we set up in 1944 to deal with the short-term processes of adjustment.

The process of economic recovery from even the greatest war is,

however, a non-recurrent problem. Formidable as the tasks of reconstruction have proved the transitional period from war to peace is now at an end. We may regard this period as an interval during which production was re-established in war-damaged countries and trade was resumed in the international economy. To say that the problems of this task are transitional does not detract from their magnitude which, as any observer of recent economic history well knows, has been formidable. But as order is restored to the international economy, and, as the dust of the vast upheaval of World War II settles, it is apparent that long-term problems, many of which were inherent in the international economy long before 1939, remain and in many cases have been accentuated by the shifts and changes of two decades of violent upheaval. It is the most important of these problems which we must now consider, the problem of how in a world economically dominated by the United States we can achieve a long-term equilibrium in international payments.

II

The structural disequilibrium which we have come to call the dollar problem must first be defined. To present a definition which would satisfy the purists would not be easy and we do not propose to try.¹ A wiser and more experienced head than that of the writer has given a good workaday description of the concept and this will serve our turn admirably. Sir Dennis Robertson has described the dollar shortage² as 'a persistent tendency on the part of the populations of the world outside North America to spend more in that region than the sum of what they are earning in that region and what the inhabitants of that region are disposed to lend to them or invest in their borders under the play of ordinary economic motive. The symptoms of the disease are a continuous pressure on the monetary reserves of the extra-North American countries...'

The dollar problem is of recent origin. Although the United States by reason of its great natural wealth developed an export surplus at a comparatively early stage in its nationhood (*circa* 1874)

¹ Defining the 'dollar shortage' has become almost an international sport among economists. For a selection of definitions see Appendix to Horst Menderhausen's article, 'Foreign Aid with and without Dollar Shortage', *Review of Economics and Statistics*, vol. 33, pp. 47-8.

² Cf. *Britain in the World Economy*, London 1954, p. 53.

and although it became a creditor nation in 1918 this did not in itself precipitate a dollar problem. Until comparatively recently means existed whereby the United States surplus could be accommodated in the world payments system and it is in great part the removal of such means, largely as a result of World War II, which has left us with the problem.¹ We must face the fact that we are not seeking to deal with a problem caused primarily by a temporary backlog of postwar demand or by the excesses of European inflation (though these have played their role) but with a structural change in the pattern of world trade, the full impact of which was suddenly and rudely thrust upon us.

Before examining the dollar problem as it exists it might be profitable to glance at the nineteenth-century system of trade to see what is germane to our present situation and what can be learned from a system which endured for half a century and which, on the whole, functioned with tolerable efficiency.

The nineteenth-century payments system was dominated by sterling as that of the twentieth has come to be dominated by the dollar. As the century proceeded the great industrial powers, Britain, France, Germany, and the United States became supreme in international trade. Of these Britain was, by reason of her natural resources, industry, maritime strength, and financial and commercial probity, first in the field. This domination of the trade of the world by the United Kingdom was important because of the contribution which it made to the establishment of a multilateral system of world payments. Because of its large and growing revenue from invisible trade Britain was able to develop a large import surplus, and the sterling disbursed abroad by British importers was available to finance trade in many parts of the world. The newer industrial countries, such as Germany, as they too became net importers, were able to pay for their excess imports by exporting to Britain or to markets of their own choice rather than by competing with Britain for the sale of manufactures in the countries from which she too imported. Sterling was able to become a world currency in which payments were made either through offsetting entries in the books of international bankers, or through investment in commercial bills of exchange. The world

¹ More precisely, the dollar shortage may be said to have appeared in World War I, to have persisted in the three or four years which followed it, and to have appeared again, and grown in stature from 1929.

became for nearly half a century an economic unit under the financial leadership of London.

This system of world payments rested on a number of important elements. First among these was the British visible import surplus which, not only by its existence but by its expansion step by step with the expansion of world trade,¹ ensured a steady flow of sterling from the United Kingdom to the countries from which she imported and to the world at large. The readiness of Britain to import in turn ensured a market for goods produced or likely to be produced in countries in which British capital was invested. Secondly, the United Kingdom with its surplus on current account was ever ready to invest capital abroad. Throughout the nineteenth century Britain was the leading supplier of capital to the rest of the world. Drawn by the magnet of profit expectation, through the agency of the great merchant bankers, the surplus savings of the growing British middle class were directed first to Western Europe and the United States and later to the British Empire and Latin America. Thirdly, the international gold standard provided a means whereby currencies were freely convertible one into another at stable rates of exchange. This gold standard, the lynchpin of the whole sterling system, was tolerable because short-term corrections of external balances were effected easily and without carrying the processes of inflation or deflation too far — either to reduce the value of money or to cause serious under-employment. This was so for several reasons but was predominantly because the deflationary tendencies of the gold standard in the world economy were annulled by expansionary long-term forces — the rate of technical advance, overseas expansion, the swift growth of population and the development of new industries stimulated by mass markets. The new international economy was equipped with a world currency, firmly based and wisely conducted financial and banking institutions, and a system of short period balance of payments adjustments which worked with tolerable efficiency and the minimum of disturbance.

The First World War destroyed this system.² The position of the

¹ The British adverse balance of visible trade rose from just over £50 mln a year in the eighteen-sixties to over £160 mln a year at the close of the century.

² Although the war hastened the end of sterling supremacy it is fairly certain that if no war had occurred this would have come by a slower process of change. No country, however great its technical leadership, could have hoped to retain indefinitely such a large share of world manufacture and trade. Britain's share of world trade had fallen in 1913 to 27 per cent as compared with 40 per cent in 1870. This was, however, a declining share of a rapidly growing total and thus

United Kingdom in the world economy was radically altered so that it could no longer fulfil the role of financial leader, and the gold standard proved incapable of dealing with the great disequilibria in national external balances which came in the postwar period. The international economy of the Victorian age was swept away and its internationalism replaced by a nationalism fired by the desire for economic and financial survival.

It is tempting to compare the nineteenth-century system with that which exists today. So far as the outlines of our new international economy are discernible there are certain superficial resemblances of which the most obvious is the domination of the world economy by one great creditor nation. One may ask why, if dollar shortage be the structural problem of the new age, was sterling shortage not the problem of the old?

There are three main reasons why sterling shortage did not occur under the old system.¹ Firstly, Britain had a large import surplus and depended on overseas sources of primary commodities. She could therefore finance, through investment, the foreign production of these with certainty that she would wish to have the resultant products. Clearly the situation of the United States today is very different. Apart from a narrow range of primary products its import requirements are few. It has a strong favourable balance of commodity trade and, while external investment might serve to alleviate the dollar problem temporarily, repayment of loans and the interest burden upon them would only serve ultimately to intensify the imbalance. When, during the 'twenties, the United States undertook heavy foreign investment the loans were most often made to countries who exported products which the United States did not want to import or who had to sell their exports in competition with the United States. If foreign investment by the United States were to play in the twentieth century an equilibrating role in world payments, it would have to be carefully regulated both as to the choice of recipient country and the nature of the production which the capital was to promote.

Secondly, the political climate of the nineteenth century was more congenial for international investment than that of the

the problem of paying for imports never arose in Britain before 1913. Cf. E. A. G. Robinson, 'The Changing Structure of the British Economy', *Economic Journal*, September 1954.

¹ For an interesting discussion of this problem see the series of articles 'Living with the Dollar' in *The Economist*, November 22, 1952.

twentieth. Britain, as an imperial power, was not only able but anxious to invest in undeveloped parts of the world. In this way incomes were augmented abroad which gave rise to an increasing demand for British products while Britain in turn was ever ready to take service or repayment of loans in the form of a steadily increasing flow of imports.

And thirdly, the structure of the British balance of payments protected the international economy from the development of sterling shortage during the successive stages of the business cycle. Britain's inelastic demand for imports and the elastic nature of the demand for her exports ensured that in times of depression Britain ran a deficit in her balance of payments. Thus if, during a slump, British overseas investment declined the deficit on current account compensated for this. In times of boom the situation was reversed. These conditions are of course not found in the American economy today. The United States' demand for imports is closely linked to national income and in recession the United States has a great expansion of its external surplus while in boom the surplus is reduced. In so far as United States foreign investment is contributing to its foreign balance equilibrium such investment is likely to slacken during the slump and resume in the recovery. The conditions are thus such that cyclical fluctuations react sharply on the American balance of payments, both in current and capital account. Each recession in the United States intensifies the dollar shortage.

The interwar period saw the rise of the United States to economic supremacy. Aloof from the destruction of World War I it was able during that war to increase industrial output by 15 per cent and in the immediate postwar years to supply goods to Europe and to the rest of the world for reconstruction purposes. During the 'twenties its industrial production increased rapidly so that in the period from 1925 to 1929 United States industrial output was estimated to be 46 per cent of the world total.¹ Although the huge favourable balance of merchandise trade of over \$4 bln in 1919 was rapidly reduced during the early 'twenties, many countries, particularly in Europe, failed to regain their pre-war position as suppliers of United States imports. Between 1920 and 1930 the merchandise export surplus of the United States with Europe averaged over a billion dollars per annum, while the European

¹ Cf. *The United States in the World Economy*. United States Department of Commerce, 1943, p. 150.

share of total United States imports, which before the war had averaged over 50 per cent, had fallen to approximately 30 per cent for the years 1920 to 1930. The swift industrialisation of the United States was changing the pattern of her trade.

This change in trade pattern was coupled with the reversion of the United States from the position of debtor to Europe to that of creditor. So long as the United States had remained a debtor to Europe the American merchandise trade surplus with Europe had presented no difficulty, for it was offset by the service and amortisation of European capital, but once the United States became a creditor it meant that Europe had no inward dollar flow to compensate for its dollar import surplus, save that which might come from American investment or from European earnings of gold and dollars in third markets. Throughout the 'twenties there was a steady flow of overseas dollar investment by the United States but when, in the 'thirties with the onset of the great depression, the flow dried up the dollar shortage became an immediate problem.

Fortunately, however, the industrialisation of the United States had another effect upon the country's trade structure, for while American imports of European manufactures declined, imports of certain raw materials and semi-finished goods from non-European countries increased. The United States consumption of such commodities as rubber, copper, tin, silk, tea and coffee rose sharply with American income, and this expanding import trade¹ served to provide a temporary balancing factor in the international payments system. Many such primary commodity imports were supplied by countries with which Europe still preserved a trading surplus, and from exports to these countries Europe was able to earn dollars which offset or partly offset the European dollar import surplus. This triangular system of trade served to protect many European countries from dollar shortage during the interwar years. Great Britain was a leading example of a country whose dollar problem was alleviated by this triangular trade structure. By the interwar period American manufacturing strength had outstripped that of Britain, and the American tariff was preventing British goods from reaching the American market. Britain on the other hand purchased large quantities of American primary commodities. The adverse merchandise balance of trade of Britain with the United States was

¹ In 1929 the United States took more than 12 per cent of the world's merchandise exports.

too large to be closed by invisibles and as a result Britain's balance of payments on current account with the United States was passive during the interwar period; in 1928 it was \$496 mln, in 1936 \$193 mln and in 1937 \$228 mln. For this passive dollar balance Britain found a partial offset in dollar-earning surpluses with her overseas empire and with China, Japan and Brazil. These did not, however, serve to compensate fully for the direct British/United States dollar deficit and Britain's dollar shortage was precariously met by short-term capital inflows from the empire, France and a number of other countries — inflows made possible by United States lending and by the current surpluses of these countries. Such a condition was, to say the least, unstable.

It is worth glancing briefly at the outline structure of the American foreign balance for the interwar period. In the immediate postwar years (1919–20) the flow of excess relief exports to war-damaged countries caused a large export surplus which was met by American government loans and grants, personal remittances and imports of gold. The depression in 1920–21 reduced imports sharply but the recovery was swift and during the rest of the 'twenties the United States external accounts were in approximate balance. During the years 1922–29 the surplus on current account (including unilateral transfers) was \$5,737 mln. This was offset by net long-term capital outflow of \$4,678 mln and gold imports of approximately \$1,000 mln. Up to the onset of the great depression there was nothing in the balance of payments position of the United States to betoken a basic structural disequilibrium. Contemporary observers may be excused for having regarded the postwar years as abnormal, the war debts payments as troublesome yet temporary phenomena, and the frequent movements of short-term capital as a symptom of political uncertainty. There was, in early 1929, no reason to anticipate the dollar shortage as a serious international problem.

The American balance reacted sharply to the depression. By 1932 imports had shrunk in volume by 40 per cent relative to 1929¹ and although they recovered after 1932 they did so slowly, reaching the 1929 volume only in 1937. In 1938 they dropped sharply once more with the recession of that year. Exports also fell with the onset of the depression in 1930 as the national incomes of other

¹ This was the same percentage decline as that for United States real national income in the same period.

countries fell and as tariffs and other protective devices against United States goods ramified. The United States' share in total world imports declined and exports did not succeed in regaining their 1929 level (volume).

Both the merchandise export surplus and the current account surplus of the United States in the 'thirties were smaller than in the previous decade and in 1935 and 1936 there was a small current account deficit. Only in 1938 and 1939 under the influence of renewed recession in the United States and rearmament in the rest of the world were there large current account surpluses. The average current account surplus for the years 1930-38 was \$295 mln and, if we exclude the first and last years, the average figure was only \$96 mln per year.¹ This current account surplus was not such as to cause serious disequilibrium had certain of the accompanying aspects been favourable. During several periods the United Kingdom had maintained a considerably larger surplus.² But factors which had served to offset the United States current account surplus in the 'twenties were absent in the 'thirties. Notably there was a virtual cessation of the flow of American investment capital overseas and, after 1934, a steady flow of fugitive capital to the United States. American foreign investment had reached its peak in 1928 and from then it declined. By 1931 there was net disinvestment of American long-term foreign holdings and, except in 1933, net disinvestment was a yearly feature until the outbreak of war in 1939. Between 1930 and 1938 total net capital inflow to the United States was approximately \$2.4 bln, of which about one third was net disinvestment of long-term foreign assets by Americans and the rest net long-term investment by foreigners in the United States.³ From 1934 there were also large inflows of short-term capital. These capital movements were largely the result of panic movements of funds to the United States before 'the gathering storm' in Europe. Their result was the steady flow of

¹ Cf R. F. Mikesell, *United States Economic Policy and International Relations*, New York 1952, p. 14.

² The average favourable current balance of the United States for the nine years 1930-38 was \$295 mln. This 'was much less than the favourable balance earned by the United Kingdom (at a much lower price level) at the time when we were building up our overseas investments, and it was about the same as our own favourable balance as recently as 1923-29 when our average surplus was \$374 mln'. Cf Lord Keynes, 'The Balance of Payments of the United States', *Economic Journal*, December 1946.

³ Cf Mikesell, *op. cit.*, p. 17.

gold into the United States which began in 1934 and which for the years 1930 to 1938 totalled some \$7 bln. If one deducts from this total the United States current account surplus for the period and United States disinvestment abroad, it seems that about \$3.5 bln of the gold flow was the result of long and short-term capital movements to the United States.

In Table XVI the balance of payments of the United States for the years 1934-39 is summarised. The figures demonstrate clearly the perversion of the normal balance of payments relationship, how to the comparatively small current account surplus was added the huge dollar demand on long- and short-term capital account as United States investments were repatriated and European capital sought security, and how this was only met by the steady flow of gold to the United States. Clearly the current account surplus was of such magnitude as could have been easily offset by American foreign lending had the political climate been suited to this.¹ Moreover, even had American foreign investment ceased and not become negative the flow of gold from the non-dollar world would

TABLE XVI
Summarised Balance of Payments of the United States
1934-39

	1934	1935	1936	1937	1938	1939
<i>Current account</i>						
Surplus (+) or deficit (-) -	+341	-156	-218	-31	+967	+732
<i>Capital account</i>						
(a) Balance of long-term capital movements -	+200	+436	+777	+521	+97	+27
(b) Balance of short-term capital movements -	+222	+1072	+431	+356	+344	+1470
Gold movements (imports) -	-1178	-1720	-1147	-1271	-1657	-3018
Unexplained items* -	+415	+368	+157	+425	+249	+789

* This category probably consisted of unrecorded short-term capital movements

¹ An important aspect of the American import/export relationship, its sensitivity to income changes, is shown in the table. The adverse balance on current account in 1937 reflects the minor industrial boom in the United States in that year just as the large favourable balance of 1938 reflects the recession which began in that year.

have been adequate to meet the current account deficit without depleting the reserves. It was the perverse movement of capital to the United States which caused the annual flow of gold from 1933 to 1938 to be more than four times the annual average surplus of the United States on current account.

In summary one may say that the imbalance in the external accounts of the United States in the 'thirties was due to several factors: to the persistent recession in that country and to restrictive commercial policies which exacerbated the current account surplus, to the cessation of American long-term foreign investment, to the inflow of fugitive capital from Europe, and to the inability of the rest of the world to adjust itself to the dollar shortage.¹ In retrospect the orders of magnitude in the imbalance do not seem great but against the background of economic and political upheaval of the later 'thirties such steps and policy measures as were appropriate to its alleviation were ill-understood and in any event impracticable. It is clear that the structural imbalance of the interwar period was a condition which could only be sustained in certain circumstances. The current account surplus of the United States should not increase, there should be a steady flow of overseas lending, and in so far as the latter did not compensate for the former other countries had to possess adequate liquid reserves to meet their dollar deficits.

The Second World War destroyed these conditions and thereby exacerbated this structural imbalance. Further it temporarily destroyed another feature by which Europe had been able in the 'thirties to sustain the dollar shortage. The dollar surpluses of Europe's debtors were temporarily eliminated and in a world of universal dollar shortage and bilateral trading it became difficult to earn dollars in third markets. The dollar had risen to the position of a key currency and in a war-shattered world in which the United States was the only large manufacturing nation capable of exporting in large volume, and where gold reserves were inadequate, neither the propensity of the United States to import nor to invest abroad was great enough to ensure the world an adequate supply of dollars.

¹ One can scarcely blame European countries for this. Such an adjustment would have entailed an intolerable degree of deflation which would have produced more problems than it solved. Some adjustment might have been made by exchange rate variations but the United States tended to regard all depreciations at this period as being competitive and to threaten retaliatory action.

III

Since 1945 the dollar problem has been acute and continuous. It may conveniently be divided into three phases, the years of immediate postwar reconstruction from 1945 to mid-1948, when the dollar shortage was acute, the years of the European Recovery Programme (1948-52) when the problem was being met by a flow of dollars from the United States and when internal economic stability was being restored in the deficit countries, and the years 1953 to the present during which the dollar shortage has been restored to a similar magnitude to that of the 'thirties. This division of the problem is somewhat arbitrary but it serves as a convenient basis for discussion.

Before proceeding to a discussion of these three phases it is necessary to survey briefly the magnitude of the dollar problem since 1945. Table XVII shows the balance of payments of the United States with the rest of the world during the postwar years, and the means whereby the dollar shortage was met during its most critical phase.

Table XVIII shows the great widening of the merchandise trade gap between Europe and the United States during this period.

During the years 1946-52 there was a great surplus in the external current account of the United States which was uncovered by any compensating condition in the capital account — the continuance of this surplus only being made possible by direct dollar grants in aid from the United States government. This great American surplus has been, however, only a crude measure of dollar shortage. Two corrections would have to be applied to the surplus figure before we could estimate the magnitude of the shortage. First, it would be necessary to add to the surplus the potential demand for dollar goods which is held in check by the discriminatory import restrictions of deficit countries. From this in turn would have to be subtracted the value of those goods from the United States which deficit countries have been encouraged to buy because of the existence of United States aid, but which would not have been purchased in the ordinary course of business. Since it is not possible to estimate these two magnitudes with any accuracy the true size of the dollar imbalance must remain unknown and all judgements based on balance of payments figures must

TABLE XVII

(a) *Balance of Payments of the United States, 1947-55*
(\$ bln)

	1947	1948	1949	1950	1951	1952	1953	1954	1955 ^a
Exports of goods and services ¹ -	-	-	-	-	-	-	-	-	-
Imports of goods and services -	-	-	-	-	-	-	-	-	-
Balance on goods and services -	-	-	-	-	-	-	-	-	-
Unilateral transfers to foreign countries (net) ² -	-	-	-	-	-	-	-	-	-
Balance on goods, services and transfers -	-	-	-	-	-	-	-	-	-
United States capital net outflow of funds (-) -	-	-	-	-	-	-	-	-	-
Foreign capital net outflow of funds (-) -	-	-	-	-	-	-	-	-	-
Gold sales (+) or purchases (-) -	-	-	-	-	-	-	-	-	-
Total -	-	-	-	-	-	-	-	-	-
Errors and omissions -	-	-	-	-	-	-	-	-	-

¹ Including military transfers under aid programmes² Including private remittances and government payments for military supplies and services³ Preliminary figures

Source: United States Department of Commerce and Survey of Current Business, March 1956

TABLE XVII

(b) *Financing of Dollar Deficit during Period 1946-49*
(*\$ bln*)

	1946	1947	1948	1949
Overall balance of United States on				
current account - - -	+7 8	+11 5	+6 8	+6 3
Means of financing				
U S Government grants - -	-2 2	-1 9	-4 2	-5 3
U S Government loans - -	-2 7	-3 9	-0 9	-0 6
U S private gifts - - -	-0 7	-0 7	-0 7	-0 5
U S private capital - - -	-0 4	-0 8	-0 9	-0 6
International Bank - - -	0 0	-0 3	-0 2	-0 04
International Monetary Fund -	0 0	-0 5	-0 2	-0 1
Foreign gold and dollar assets -	-1 9	-4 5	-0 8	0 0
Total - - - -	-7 9	-12 6	-7 9	-7 2
Errors and omissions - -	+0 1	+1 1	+1 1	+0 9

Source United States Department of Commerce The Balance of Payments in the United States 1946-48, 1949-51 and Survey of Current Business, March 1950

TABLE XVIII

European Trade with United States, 1938-55
(*\$ mln*)

Year	European imports from U S	European exports to U S	Excess of imports over exports
1938	1,379	478	901
1945	5,492	397	5,095
1946	2,892	612	2,280
1947	5,556	732	4,824
1948	4,488	936	3,552
1949	4,476	792	3,684
1950	3,132	1,212	1,920
1951	4,416	1,812	2,604
1952	3,972	1,872	2,100
1953	2,971	2,133	838
1954	3,300	1,871	1,429
1955	4,514	2,239	2,275

Source OEEC Foreign Trade Statistical Bulletin

necessarily be tentative. If we except the years 1945-49, during which temporary influences of postwar reconstruction and adjustment intensified dollar imbalance, it would appear that \$2-\$3 bln per annum might be the magnitude of the shortage. This is not a staggering figure and, when related to other magnitudes in the pattern of international trade, it is not much greater than the dollar imbalance during the interwar period. The following table compares the United States merchandise trade balance and balance on current account in the years 1950-55 with that in certain pre-war years.

Alarm as to the magnitude of the dollar scarcity should also be tempered by considering the trade balance items relative to the changes which have taken place in American production. By 1951 United States industrial production had rather more than doubled as compared with pre-war. The volume of United States exports had moved in similar proportion and although the import volume was only 50 per cent greater the terms of trade had so moved against the United States that by 1951 the value of United States imports had increased slightly more than the value of her exports. The terms of trade have thus played an important part in determining the magnitude of the postwar dollar problem. Had they not moved against the United States the shortage would have been much greater than it has been.¹

TABLE XIX

United States Balance of Payments on Current Account
(\$ bln)

Year	Balance of merchandise trade	Balance on current a/c	Trade balance as per cent of exports	Current balance as per cent of exports
1924-29	0.82	0.77	16.2	15.2
1933-38	0.34	0.27	13.0	10.2
1936-38	0.48	0.38	16.7	13.5
1950	1.0	1.7	9.9	17.0
1951	2.9	3.6	20.6	25.7
1952	2.5	2.4	18.8	17.6
1953	1.5	0.5	12.1	4.03
1954	2.5	1.8	19.5	14.0
1955	3.0	2.0	20.7	13.8

Source: Compiled partly from data given by R. F. Harrod (cf. IMF Staff Papers, April 1953, p. 9), and partly from sources of Table XVII above.

¹ The terms of trade of the U.S. (as shown by dividing the index of import prices by that of export prices) were 106 in 1953 as against 77 in 1938. The corresponding index for the U.K. was 92 in 1953 as against 100 in 1938.

The current account surplus of the United States is then in great part the natural and expected development of the interwar years. Not so the capital account. Here the normal items to which we may customarily look for the offsetting of a current account surplus have been absent. Not until 1950 was there a significant resumption of American long-term overseas investment and then only on a limited scale. In the absence of this, and with gold transfers shrunk in relative importance, the non-dollar world has been vouchsafed a temporary respite only by virtue of the flow of dollars made available first through reconstruction loans, later under ERP, and latterly under the defence aid programme.

One feature of the capital account cannot escape our notice — the rôle now played by gold as a means of international payment. Although the dollar prices of goods entering into international trade had increased about $2\frac{1}{2}$ times in 1950–51 as compared with 1937–38 the price of gold has remained stable at the United States buying price of \$35 per ounce, settled in 1934, and the value of gold as a means of international settlement has been commensurately diminished. Had the price of gold been allowed to rise at the same rate as other dollar prices the means of settlement of the non-dollar world would have been greatly increased — not only by the upvaluing of gold but by the induced increase in its production. Harrod estimates that, if the gold production in 1950–51 had been one-third greater than in 1936–38 and if this production (less the normal outflow to industry and the arts) had been raised $2\frac{1}{2}$ times in its dollar price, this would have given an annual value of \$2,549.9 mln for new gold produced outside the United States and the USSR for monetary use. Such a figure would have more than covered the United States' current surplus for 1950 to mid-1952 of \$2,462 mln and allowed the small United States overseas investment of \$851 mln to augment non-American dollar reserves.¹ This estimate is by no means far-fetched and it shows clearly how the fixed price of gold has robbed the non-dollar world of one means of dealing with the American current account surplus.

There has been, perhaps, a widespread tendency both to overrate and to underestimate the importance of the dollar problem. In the immediate postwar years when all statistical estimates seemed to show it to be of formidable size, and when one payments crisis

¹ Cf. 'Imbalance of International Payments', *IMF Staff Papers*, April 1953,

demand and the European economies had their nerves and wits tried to the full by a series of payments crises

World War II had a double impact on the international economy, it created through physical destruction, constricted capital formation, and perverted production, temporary conditions with which the normal processes of international payments and adjustments could not hope to deal, but it also served to intensify and accelerate tendencies which had long been at work and of these none was greater than the relative decline in the economic importance of Europe¹ and the end of the dominant position of Great Britain in the world economy. In so far as the war accelerated basic changes, it made them more difficult to interpret and to deal with.²

The impact of the war upon the trade of the European and British economies can be seen from the following tables comparing the balance of payments of each in 1947 with that in 1938

Table XX shows the impact of the war upon the external position of Europe and of the United Kingdom. For both the pattern is similar. Approximate balance in 1938 became a large deficit by 1947 — the year in which postwar payments difficulties were at their worst. In both cases the visible trade balance worsened during the period and the balance of invisibles was transformed, becoming unfavourable and augmenting the trade deficit. The year 1947 found both Britain and Europe at the nadir of their fortunes. The deficit of \$7.6 bln in European payments was such as to daunt the most optimistic and hopeful observer.

For this deterioration in European payments several influences were responsible. Firstly Europe's productive capacity, and so her capacity to export, had been reduced by war destruction and the deterioration of capital equipment, while her need for imports was

¹ Europe's share of world export trade shrank from more than 50 per cent before World War I to about 45 per cent in the interwar period, and 35 per cent in the years 1948 to 1950. Cf. Ingvar Svennison, *Growth and Stagnation in the European Economy*, United Nations, Geneva 1954.

² One way in which the war served to intensify the difficulty of adjustment to long-term change was that it dissipated European stocks of foreign assets. If, for example, the war had not forced Britain to sell £1,118 mln of foreign assets and if by its induced inflations it had not reduced the settlement value of the new gold of the Sterling Area, adjustment to the dollar problem would have been very much easier.

Another example of how the war intensified the dollar problem was the way in which trade relations among countries of the dollar area were strengthened during the war itself so that the area emerged from the war less dependent upon imports as well as with a greater capacity for supplying goods essential to the economies of other areas.

TABLE XX
Europe's Balance of Payments
 (\$ bln at 1948 prices)

	1938			1947		
	<i>With United States</i>	<i>With other non- European countries</i>	<i>Total</i>	<i>With United States</i>	<i>With other non- European countries</i>	<i>Total</i>
European imports (f o b) - -	1 3	4 2	5 5	6 1	7 8	13 9
European exports (f o b) - -	0 6	3 1	3 7	0 9	5 5	6 4
Balance on trade account - -	-0 7	-1 1	-1 8	-5 2	-2 3	-7 5
Balance of invisibles -	+0 3	+1 5	+1 8	-0 5	+0 4	-0 1
Balance on current account	-0 4	+0 4	—	-5 7	-1 9	-7 6

Source United Nations Economic Survey of Europe in 1948, p. 112

United Kingdom Balance of Payments
 (£ mln)

	1938	1947
Visible Trade		
Imports (f o b) - - - -	835	1,541
Exports and re-exports (f o b) - - - -	533	1,100
Balance of visible trade - - - -	-302	-441
Government overseas expenditure (net)	-16	-207
Other invisibles (net) - - - -	+248	+18
Balance on current account - - - -	-70	-630

Source 19th Annual Report of BIS

immediate, great, and for a time almost insatiable. If production was to be expanded new capital equipment had to be provided and stocks of raw materials built up. At the same time there was every incentive for European governments to sponsor a rise in the standard of consumption of populations which had long been subject to war-privation and short-commons. The pressure for increased imports, therefore, extended over a wide range, both of capital goods, raw materials and primary products. The fact that many commodities were, for the time being, only obtainable in the United States diverted much European demand to that country and explains the relatively greater deterioration of Europe's balance with the United States. In certain European countries, notably Britain and France, the deficit was aggravated by domestic inflation created largely by over-ambitious capital development programmes. It is difficult to say by how much the deficit of these countries could have been reduced if domestic fiscal and monetary policies had been fearlessly used to control inflation but it is certain that some reduction could have been effected.¹

The deterioration of the trade balance in 1947 as compared with 1938 was also due to the failure of exports to recover their pre-war volume. While imports rose quickly with the return of peace, exports had, by 1947, only risen to some 80 per cent of their pre-war volume. Moreover, Europe's postwar terms of trade were less favourable than those in the 'thirties. The prices of primary products, which form Europe's main import group, had risen more sharply than had the prices of the manufactured goods which are her main exports. The adjustment in the terms of trade following the devaluation of sterling in 1949 was probably necessary to realign the cost/price structures of the dollar area and the non-dollar world but the great further deterioration in 1950 and 1951 was due to special and transitory influences. Subsequent falls in primary commodity prices have restored Europe's terms of trade to approximately the mid-1950 level, which may be assumed to be near the normal for the new postwar equilibrium. These, however, are 25 per cent worse than in 1938 and involve an additional burden on Western Europe equal to 44 per cent of its 1938 volume of exports. This worsening of the terms of trade militated heavily against the United Kingdom, who, while striving to increase her

¹ For a good argument of the case for disinflation in 1946-47 see R. F. Harrod's *Are These Hardships Necessary?*

production and export sales, was hard put even with rising export volume to obtain even the minimum of primary commodity imports. Quite apart from relative price movements the size of the European trade deficit was much increased by the general rise in prices (approximately doubling) which had taken place between 1938 and 1947 and which was bound to worsen the trade balance of countries accustomed to running an import surplus. Finally, Europe suffered, as a result of the war, a large reduction in income from foreign investments¹ and shipping receipts, while there emerged large invisible payments due from Europe to overseas countries.² The overseas commitments of European governments were also heavy. In large part the heavy deficit in Britain's balance of payments in 1947 was due to heavy government expenditure abroad. France, heavily committed in Indo-China, suffered in similar fashion.

The United States was conscious of the problem set by its position in the postwar world. It was clearly seen, even during the war, that the large surplus on account of goods and services which the United States would have with the rest of the world would not be accompanied by any appropriate means of settlement or capital transfer and that the framework of a new international payments equilibrium could only be built slowly and by conscious effort. Clearly, if economic collapse in Europe was to be averted it would be necessary for the United States to supplement the dollar resources of Western European countries. This was realised, but until the inauguration of the European Recovery Programme in the spring of 1948, American assistance was mainly of an *ad hoc* character and showed little appreciation of the scale and probable duration of the dollar problem. So far as a programme could be said to exist it was based on division of function. Immediate relief needs were the responsibility of UNRRA, credits for currency

¹ This decline was due partly to the widespread liquidation of investments during and after the war and partly to the reduced earning capacity of those investments that remained. Rough estimates suggest a fall of over \$500 mln in Western Europe's income from foreign property between 1938 and 1950-51 even in money terms. Cf. *Economic Survey of Europe Since the War*, ECE, Geneva 1953, p. 11.

² During the war the United Kingdom increased its sterling liabilities to overseas countries by over £2.5 bln and incurred debts to the United States and Canada of about \$1 bln. Immediately following the war Europe borrowed through reconstruction loans from America. In 1946 and 1947 Britain borrowed \$4.4 bln from the United States and \$1.25 bln from Canada. France borrowed \$1.9 bln during the same period. *ibid.*, p. 11.

stabilisation were the responsibility of the IMF, and loans for capital equipment and development the task of the IBRD. The history of the various means whereby the dollar problem has been met has been largely a history of American realisation of the stature of the problem. At first it was thought that a series of stabilisation and reconstruction loans, similar to those made after World War I, would be sufficient to augment existing facilities and to provide Europe with temporary liquidity to finance reconstruction. When it became apparent that the problem was formidable and would not yield to such puny attack, the United States Government embarked upon the European Recovery Programme.¹ Yet even in 1948 it was the prospect of possible social upheaval and the spread of Communism to Western Europe, rather than any full realisation of financial responsibilities, which motivated the programme.

It is not possible to examine in detail the various measures of United States dollar aid. It is, however, appropriate to show the means whereby the international economy survived the postwar dollar problem without serious disaster. In the second part of Table XVII (page 321) are set out against the current account surplus of the United States the various sources from which this surplus was met. It will be seen from this that in 1946 much of the United States surplus was financed by United States government grants and loans and by the liquidation of gold and dollar assets by deficit countries. In the former category fall not only the American loan to Britain but the Export-Import Bank loan to France and the other reconstruction loans. The item includes also a large amount of United States relief assistance made available through UNRRA and through military occupation forces. As 1946 passed it became clear, however, that the loans made by the United States were too small. Moreover, their purchasing power in the United States was much reduced by the sharp rise in prices which took place there in 1946 and 1947.² UNRRA relief assistance ended in 1947 and by the middle of that year much of the dollar loans made by the

¹ American failure to realise the magnitude and scope of the European reconstruction problem was unfortunate. Not only were the reconstruction loans too small but they carried onerous conditions some of which it proved impossible to honour. The enforcement of the Sterling Convertibility clause of the Washington Loan Agreement was particularly unfortunate. Moreover, these loans provided later dollar repayment burdens for the external balances of Europe.

² During the period August 1945 to April 1946 United States wholesale prices rose by about 7 per cent but after the ending of price controls in June 1946 wholesale prices rose by 25 per cent in the second half of the year.

United States and Canada to the United Kingdom had been spent. When on July 15, 1947, Britain honoured her obligations under the Anglo-American Loan Agreement to make sterling convertible for non-residents the experiment failed. There were large conversions of sterling into dollars which, in the existing state of the British balance of payments, created an intolerable drain upon the balance of the Loan and on the liquid reserves of the Sterling Area. On August 20 sterling was again made inconvertible and the British balance of payments was protected by intensified import controls. The United Kingdom in 1947 had the largest adverse balance on record. The French external balance was also heavily adverse, as were those of most of the Overseas Sterling Area countries. The figures for 1947 in Table XVII (b) reflect these conditions. The large figure (\$3,895 mln) for United States long-term government loans shows the drawings made upon the balances of reconstruction loans. The IMF, whose currency dealings began in March 1947, had to make advances of \$665 mln in 1947 and 1948. Finally, the year 1947 saw the largest liquidation of gold and dollar assets so far made. It was a disastrous year for the international economy but it marked a turning point. In 1948 the European Recovery Programme was offered, accepted and implemented. The European balance of payments improved and a start was made with measures for freeing intra-European trade from the constriction of bilateralism. The period of greatest difficulty for the deficit countries was during the last months of 1947 and in early 1948 when, with the loans exhausted, some months were to elapse before Marshall Aid became available. During this time the brunt of the dollar shortage had to be borne by national reserves and by drawings upon the IMF.

The improvement in Europe's balance of payments in 1948 was considerable. The reduction in the deficit was of the order of \$2,000 mln, or more than a quarter, as compared with 1947. Moreover, the reduction was greatest in the deficit with the United States. This improvement was partly due to an improved merchandise trade balance¹ and partly to a change in the net position on invisible transactions from an unfavourable balance of \$100 mln in 1947 to a favourable balance of some \$600 mln in 1948, largely the result of an improvement in Europe's shipping position. From 1948 onwards the payments position of both Europe and of

¹ In spite of a considerable deterioration in Europe's terms of trade

the world relative to the United States improved steadily, and although there were setbacks in 1949 and in 1951 it was clear that the dollar problem was assuming more manageable proportions.

The nature of these setbacks is, however, important for they serve to demonstrate the way in which the dollar problem may at any time pass from a controlled disequilibrium, offset by some appropriate means, to a condition of crisis threatening the stability of the whole international economy. The first of these setbacks came in 1949. In the early months of that year the levels of output and employment of the American economy began, for the first time since the war, to decline. In the second quarter of 1949 gross national product in the United States was 5 per cent lower than in the last quarter of 1948, but imports had declined by some 15 per cent. The recession was a minor one, involving only a momentary faltering of the rhythm of the American economy. By comparison with the recessions of 1938 or 1932 it should have provided a mere cat paw on the surface of the international economy, but in the circumstances it proved a wave capable of upsetting many large and unwieldy vessels. As American imports from the Sterling Area declined the gold and dollar reserves of the Area were drawn upon at a quickening rate to meet the widening dollar deficit. British exports to the United States also fell. The dollar deficit of the Western European countries widened dangerously. During the spring and summer the drain continued and there were fears for the solvency of the Sterling Area reserve pool. Rumours of a sterling devaluation gained credence and, in spite of the exchange control, speculation against the currency increased. In September sterling was devalued and, as other currencies followed, there was a general reorientation of exchange rates *vis-à-vis* the dollar.

Whether devaluation was in the circumstances the appropriate step is open to debate but this need not concern us. What is here important is how this slight recession, caused by the reduction of stocks in the United States, by temporarily intensifying the dollar shortage had such a destabilising effect upon the world economy. It seemed to demonstrate that in future the dollar problem would be subject to such intense phases when the American economy suffered even minor lapses from full employment. If a major recession were to occur it seemed that the payments system of the world would be thrown into confusion.

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Whether devaluation was in the circumstances the appropriate step is open to debate but this need not concern us. What is here important is how this slight recession, caused by the reduction of stocks in the United States, by temporarily intensifying the dollar shortage had such a destabilising effect upon the world economy. It seemed to demonstrate that in future the dollar problem would be subject to such intense phases when the American economy suffered even minor lapses from full employment. If a major recession were to occur it seemed that the payments system of the world would be thrown into confusion.

The lesson of 1949 was taken, perhaps, too much to heart by the

non-dollar world In 1953 the American economy once more suffered temporary decline in similar magnitude, yet this time the foreign balances of the European countries were unaffected In fact during the period of the recession the Sterling Area balance of payments strengthened and was more favourable than at any time since the war The macro-economic model of the transmission of income variations from country to country is obviously one which can only be applied after due consideration of accompanying circumstances Suffice it to say here that the dollar shortage is likely to be much influenced by income variations in the United States The greatest contribution which that country can make to international stability in the future is a high and stable level of domestic income

The second setback to payments recovery came in 1951 The outbreak of war in Korea and the fear of widespread conflict gave rise to a wave of panic buying of primary commodities for stock In this the United States played a leading part The prices of primary commodities rose sharply and the terms of trade turned heavily against the European manufacturing countries, particularly Great Britain The rise in raw material prices invoked cost inflation in Great Britain, and raised domestic prices In due time wage increases and rising demand intensified the inflation and in 1951 the combined result of adverse terms of trade and domestic inflation was a sharp deficit in the balance of payments Britain's favourable balance of payments of \$770 mln in 1950 became unfavourable to the tune of \$1,430 mln in 1951 and there was a sharp increase in the deficit with the dollar area This crisis was short In 1952 the balances of payments of most European countries were again favourable Primary commodity prices had fallen steeply and inflation had been brought under control in the deficit countries Although this crisis of 1951 was not specifically a dollar crisis, in the sense that it came from changes in the United States economy or that it involved a special worsening of the dollar problem it nevertheless served to prolong the disequilibrium of the postwar period Moreover, it showed the important role played by raw material prices in determining the external position of certain countries Since the demand of the United States does much to determine such prices, stability of such demand would be a considerable contribution towards the maintenance of international equilibrium

The years 1952 and 1953 saw a steady and rapid improvement in the international payments situation. The favourable balance of Great Britain continued and the external surplus of £225 mln in 1953 was the highest since the war. In Europe the OEEC countries maintained an annual current account surplus of \$1½ bln in 1953-54. Meanwhile the export surplus of the United States shrank steadily until in 1953 the trade balance was in approximate equilibrium.¹ 1954 was, in spite of the United States recession, a year of easy payments conditions. Although the Western European trade deficit with the United States was some \$1,423 mln, this was more than covered by direct United States military expenditure in Western Europe of \$1,431 mln. The existence of certain government grants and remittances thus enabled European dollar reserves to be augmented.² The large military receipts from North America have thus come to play an increasingly important role in Western Europe's balance, enabling it still to show a surplus on current account despite very considerable expansion of imports.

The condition of the American balance of payments and the strength of the European currencies, notably sterling, has led some commentators to argue that the dollar problem was solely one of postwar adjustment. The writer believes this view to be erroneous for the following reasons: (1) the problem existed before the war and forms part of a long-term process of structural change in the world economy, (2) the present world demand for dollar imports is kept below its potential by direct controls and discrimination, (3) much of the improvement in the American balance has been due to American defence purchases abroad, (4) the present balance depends more on political than on economic factors, (5) liquid reserves outside the United States are still dangerously low, and (6) we must expect temporary improvements and intensifications of dollar shortage under the influence of economic conditions in the dollar and non-dollar worlds, it may well be that from time to time

¹ To be precise, if military deliveries are excluded, the United States current balance changed from a surplus of \$1,829 mln in 1952 to a deficit of \$62 mln in 1953.

² The relatively stable overall current balance of OEEC countries between 1953 and 1955 conceals important divergences in the balances of individual countries and certain countries — notably Germany, Holland, Scandinavia and the United Kingdom — experienced a progressive worsening of their foreign balances — a feature due in several cases to excessive domestic demand and boom conditions in these countries.

a concomitance of favourable factors will reduce the dollar shortage to negligible amount. It seems clear that the intense post-war phase of the dollar problem ended in the early 'fifties and that we are now faced with the structural problem of dollar shortage upon which the problems of war and its aftermath were for a time superimposed.

THE DOLLAR PROBLEM

I

A SOLUTION of the dollar problem may be sought by one or more of the following means

- (a) An expansion of exports to the United States,
- (b) By earning dollars in multilateral exchange,
- (c) A reduction by the non-dollar world of imports from the United States,
- (d) Depreciation of the exchange rates of deficit countries,
- (e) The establishment of a high and stable level of United States overseas investment,
- (f) By an increase in the American buying-price of gold

Let us consider each of these possible solutions in turn

(a) It was generally acknowledged in 1945 that in the postwar years Europe would not only have to achieve a large increase in the total volume of its exports but that the export expansion would need to be concentrated as much as possible in the dollar area, or in countries where dollars could be earned. In Table XXI a comparison is made between Europe's exports to certain areas before and after the war.

Although Europe's achievement in expanding exports has been great it has been insufficient and it has not been distributed as required. The 40 per cent increase in total exports was not even sufficient to cover deterioration in the terms of trade, loss of income from investments and diminished invisible earnings. Nor was the increase sufficiently concentrated on the dollar area. It will be seen from the table that the greatest increase in exports has been to the overseas dependent countries and that this expansion has been at the expense of a fall in exports to other non-dollar countries. Such a pattern of export expansion could only have contributed to a solution of the dollar problem if the overseas depen-

dencies had been earning a net dollar surplus, but such was not the case

TABLE XXI
Western European Exports to Other Areas
(\$ mln at 1948 prices)

<i>Destination</i>	1938	1948	1950	1951	<i>per cent increase</i>
					1951 over 1938
Dollar Area - - -	2,000	1,700	2,750	3,300	65
Overseas Sterling Area -	2,650	3,350	4,450	4,650	75
Dependent territories -	950	1,300	2,000	2,300	143
Non-dollar Latin America	1,200	1,000	1,350	1,650	37
Other overseas countries -	1,600	950	1,350	1,550	-3
Eastern Europe - -	1,600	800	750	700	-56
Total - - - -	10,000	9,100	12,650	14,150	41

Source *Economy Survey of Europe since the War* ECE, Geneva 1953

When one turns to exports of finished manufactures, however, the picture is a little more cheering. Since such exports offer the best avenue for a concentrated selling drive in the United States it is well to focus attention upon them. In Table XXII are shown the increases in this class of exports from selected areas to the United States.

TABLE XXII
Indices of Exports of Finished Manufactures to the United States,
1950-51 avg
(1936-38=100)

<i>Exporting Region</i>	<i>Quantum</i>	<i>Total Value of Sales</i>
World - - - -	140	355
OEEC countries - -	187	321
United Kingdom - -	165	319

Source Federal Reserve Bank of New York, *Pattern of U S Import Demand Since 1923, Some New Index Series and their Application*, New York 1952. For a fuller version of the above table see R. F. Harrod, *Imbalance of International Payments* IMF Staff Papers, vol 3, no 1, p 16

The quantum figures give a measure of Europe's export effort. To have established exports in 1950-51 at a volume 87 per cent higher than that of pre-war represents no mean achievement. It is the greater pity that the change in the terms of trade did so much to reduce its benefit. As can be seen from the value figures the fact that the prices of OEEC countries' exports rose less than those of other countries reduced relatively the dollar proceeds of OEEC exports. In spite of this an increase of 221 per cent in the value of exports of finished manufactures from Europe to the United States was in itself considerable.

More latterly in the period 1950-55 European exports to the United States have been disappointing and while exports to other non-European countries expanded steadily, dollar exports rose only slowly, more or less in step with the U.S. Gross National Product. There was also a setback in 1954, when European exports to the United States fell as a result of the slight recession in that country.

The ability of Europe to expand its exports to the United States depends in the short-run, upon the possibility of gaining a larger share of the American demand for imports by reducing relatively the prices of European products, and in the long-run upon the rate of growth of American national income and of the proportion of the increase in income which is spent upon imports.

If short-run gains in European exports to America are to be made the demand for European products in the United States must be price-elastic. In the absence of this condition such gains as may be made through superior quality or speedy delivery are insignificant in magnitude and in any event transitory. In a survey of United States import demand¹ some general conclusions as to the elasticity of such demand have relevance to this problem. The writers find that with all classes of imports, save finished manufactures, imports depend more upon the movements of United States income than upon relative prices. In the case of finished manufactures, however, demand is sensitive to price and the writers conclude that 'the measurements of United States import demand for manufactured products certainly lend support to the belief that the countries of Western Europe, which are the main suppliers of manufactured imports, have ample opportunities to strengthen

¹ This is the Federal Reserve Bank's survey referred to as a source for Table XXII.

their position in the American market if they pursue policies which will permit their exports to compete price-wise with American products' The Report gives several estimates of the price elasticity of United States import demand for certain periods and for imports from different regions Of these the most important for our purpose is the price elasticity of United States demand for finished manufactures imported from ERP countries These differ, according to the period taken and the method of computation, but the figure of 2.5 for the years 1923-37 is a representative one.¹ Harrod shows² that 'if the figure of 2.5 is applied to OEEC exports of finished manufactures to the United States in 1950-51 (\$641 mln per annum) and if a reduction of 30 per cent in the average of prices charged is assumed', that the increase of American imports of such goods from Europe would be only \$144 mln If the same conditions were applied to United States imports of manufactures from all quarters (\$1,195 mln) the additional imports would only be \$269 mln Thus it can be seen that, even on the most optimistic assumptions, the contribution which can be made towards closing a dollar gap of some \$2 bln by price reductions (or by currency devaluations) in manufactured goods offered to the United States market is very small indeed.³ Some contribution can be made, and so far as it goes it is worth having, but the fact seems plain that, in the short-term, only a small contribution towards closing the dollar gap can come from this source

It is generally agreed that 'the most important single "systematic" factor determining the volume of American imports is the level of economic activity in the United States' If we may assume this close connection we may expect imports to rise with the secular rate of growth of income The President's Materials Policy Commission in its 1952 report to the President of the United States⁴ estimated that a 3 per cent per annum rate of growth might be expected to continue, which, compounded, results in a doubling of income in 25 years If this assumption be correct American

¹ For the 'thirties the figure is higher at 2.9 whereas in the 'twenties demand was almost insensitive to price, the figure being .7

² *Op. cit.*, IMF *Staff Papers*, April 1953, p. 17

³ There is no need to discuss the Federal Reserve calculations in detail No doubt there is some scope for such discussion but the broad bases of the calculations which Harrod makes are highly acceptable and are support enough for the estimation of orders of magnitude made above

⁴ *Resources for Freedom*, vol. 1 Foundations for Growth and Security, Washington 1952.

national income would by 1975 be double its 1950 level, and, if the income elasticity of American demand for imports is unity,¹ we might expect a doubling of the volume of imports. Such long range estimates are, however, subject to such error and influence by unforeseen circumstances that it would be unwise to place too much reliance on them. The figures given by the Federal Reserve for income elasticities of demand for different classes of imports to the United States differ fairly widely. Moreover, the figures are for the interwar period and there is every reason to suppose that there have been changes in postwar years. The farthest that one can go is to say that American imports are likely to expand in volume as American income increases. If this expansion is accompanied by a conscious limitation by non-dollar countries of imports from the dollar area the alleviation of dollar shortage may in the long run be considerable.

But the long run American demand for imports depends not only upon the secular rate of growth of American income but upon the proportion of income which is spent upon imports, that is upon the propensity to import. This is likely to be determined by a number of factors of which we may mention two. If, as has been pointed out, the maintenance of a high level of imports of all kinds depends upon continuous full employment in the United States then this in turn pre-supposes a high level of capital investment. There is therefore some danger that foreign exporters will be continually priced out of the American market, or of markets where they are in competition with the Americans, as a result of the constant rise in American productivity — the result of the high level of investment. Thus, whether full employment is maintained in the United States or not, there is little hope of Europe competing effectively with the United States.² This argument assumes, however, that such increases in productivity as take place in American industry are passed on to the consumer in lower prices. This is not likely. The increasing power of American labour unions makes it more probable that the rising productivity will increase workers' real incomes via increases in money wages. If this proves to be the case the American demand for consumer goods will increase and give

¹ The Federal Reserve estimates for income elasticity of American demand for finished manufactures imported from ERP countries vary only slightly and are all within the range .8 to 1.4. Cf. *op. cit.*, Table XV, p. 75.

² Cf. T. Balogh, 'The United States in the World Economy', *Bulletin of the Oxford Institute of Statistics*, October 1946, vol. 8, no. 10.

excellent opportunities to European countries to export to the United States. A close study by Europeans of the American market for finished consumer goods under full employment may yield rich rewards in the future.

A second factor influencing the long-term movement of the United States propensity to import is the American demand for raw materials. Almost 60 per cent of United States imports consists of raw materials and intermediate products for industrial use. The level of demand for these in the future is somewhat problematic. American industry is using less raw materials — the ratio of imported raw materials to the value of American manufactures having fallen from 7-8½ per cent in the late 'twenties to 3-4 per cent today. A survey of the list of United States raw material imports is not encouraging. Although the Paley Commission reported that United States natural resources in certain metals were near exhaustion, imports of scarce metals are likely to be made from Canada and Latin America and are not likely to benefit Europe. For such materials as the non-dollar world has to offer — e.g., natural rubber, tin and fibres — the American demand is likely to fall rather than rise. The Paley Report estimates that by 1975, assuming a doubling of United States output, and, presumably, doubled exports, the American import of Sterling Area primary commodities will have fallen.

There is little comfort then to be derived from a review of the long-term prospects for American imports. The result will be a balance of countervailing influences and is at this stage too problematic to be the basis of any useful estimate.

Lastly, we must ask what alleviation of the dollar shortage might result from a reduction in the United States tariff. Tariff changes bring changes in selling prices of the imports upon which the duties are levied and are therefore limited in their effects by the same elasticity conditions as govern other import price changes. It is, therefore, only in the range of imported goods for which the demand is price-elastic, namely finished manufactures, that tariff reductions are likely to result in increased sales in the United States. But this is just where tariff reductions are least likely to be made. American tariff changes are always selective and it is in this range that the home producers in the United States will press for a raising of tariffs on the goods which are beginning to compete with them in the United States market. There is every reason to fear

that where non-dollar countries succeed in increasing their sales in the United States by any significant amount the pressure upon the administration to raise tariffs will be great and may be acceded to.¹ The only condition under which a lowering of the tariff would give a large measure of assistance to sales in the dollar area is where there was a simultaneous lowering of export prices. It is too much to expect such a condition. The best assumption on which we should build our hopes is that the United States tariff should not be raised against us. In order to contribute significantly to the dollar problem tariff reductions would require to be on a massive scale — far greater than we dare hope for.² All this is not to say that we should not press the United States hard for tariff reductions and still more for simplification of customs procedures. Over a span of years a progressive lowering of tariffs would contribute to the force of the non-dollar countries' export drive to the United States. It would not, however, as some Europeans appear to believe, result in a speedy expansion of American imports.

(b) It is possible to earn dollars in other countries than the United States — either in other dollar area countries such as Canada or parts of Latin America, or in other countries which may be willing to take European exports in place of those of the United States. For Britain the prospects are most favourable in Canada where British goods are popular and have the advantage of Imperial Preference.³ Moreover, Canadian national income is likely to ex-

¹ Although United States' customs duties have been progressively reduced during the past twenty years under the Reciprocal Trade Agreements Programme, concern for domestic interest still powerfully operates when any attempt is made to reduce the tariff. There is every reason to suppose that with the same motive the tariff might be raised. The principle of avoiding injury to American industry was incorporated in an amendment to the Reciprocal Trade Agreements Act in 1948 and, after deletion in 1949, was reintroduced in 1951. This provision requires the administration to justify in advance to Congress any proposal to reduce duties beyond 'peril points' fixed in advance by the United States Tariff Commission. Moreover all trade agreements negotiated by the United States since 1943 have contained an escape clause which allows either party to modify or withdraw a concession if serious damage is done to its domestic producers. This escape clause militates against tariff bargaining between the United States and other countries, the latter fearing that an American concession given as a *quid pro quo* may later be withdrawn.

² It has been estimated that duty concessions on finished manufactures made by the United States at the Torquay Conference (1950-51) of the contracting parties to GATT would induce additional imports of such goods of only about \$5 1 mln. Cf *The Pattern of U.S. Import Demand Since 1923*, Federal Reserve Bank of New York, May 1952, pp. 54-5.

³ Although Canada has a passive trade balance with the U.S. there is a considerable flow of dollars to that country from U.S. investment in her great natural resources.

pand and, if Britain can capture a high proportion of the resultant increase in Canadian imports, this will contribute to her dollar earnings. The prospects in the dollar area countries of Latin America are less bright, for the United States is firmly entrenched in these markets and has the advantage of close proximity.

As long as the major European currencies remain inconvertible the earning of dollars in these so-called 'third markets' is conditional upon the importing countries being prepared to pay for European goods in dollars, which implies that the goods must be urgently required, but as soon as convertibility of European currencies is achieved this difficulty will end and there will be a great opportunity to contribute towards dollar solvency in this way. In the new international economy which will emerge as soon as sterling and other European currencies become convertible, multilateral trade will make it possible to evolve over a long period a new trade structure which may ultimately eliminate the dollar problem. The primary condition of such a structure would be that a sufficient number of countries existed who had dollar surpluses which might be earned by those countries with dollar deficits. Europe is certain to fall into the latter category. There are, however, grounds for hope that with the secular increase in American imports and with some restoration of American foreign investment a group of expanding countries seeking manufactures in return for primary products will emerge from which Europe may earn its dollars.

A development of European exports to third markets will inevitably bring Europe into sharp competition with the United States. In the case of expanding countries like Canada this competition will be for a growing demand, particularly for capital goods, in the case of older countries competition will develop as European countries seek to displace United States goods from the market and substitute their own. In both cases, especially in the second, Europe will have to fight for expanding sales by low prices, market study and selling campaigns. It is usual to think of this type of competition purely in price terms and to assume that by reducing costs and selling prices a sufficiently large sector of the market will be captured to increase the foreign currency earnings. This is not necessarily the case. A reduction in export selling prices may divert such a small part of the total demand to the seller as will fail to offset the reduction in his revenue due to the lower

price This applies to efforts which Europe may make to replace United States exports in third markets and substitute her own In any competitive price-cutting with the United States Europe is likely to be at a disadvantage For this reason competition would be wisely based if waged on the basis of quality, technical excellence, speedy and regular delivery and the other factors which we are all too prone to dismiss as of secondary importance but which, in the real world, do at least as much as price to determine whether a given sale is made or a contract awarded

In competing with American goods in third markets there have been certain difficulties There is first the composition of United States exports to such markets More than a third of these consist of food and raw materials with which Europe not only cannot compete in export but is forced to import herself — often from the United States Then secondly, there is the fact that, in the field of manufactures, much of the demand in third markets is and has been for capital goods of which Europe has until recently stood in need for her own re-equipment and of which she has had little as an exportable surplus Thirdly, in order to compete effectively with the United States in the field of manufactured products Europe must be prepared for a certain adjustment of the pattern of her production Such changes are not made quickly and have been difficult to make while Europe is recovering from war Lastly, the United States is advantageously placed in the matter of adjusting production to export by reason of the fact that her export sales of manufactured goods form only a small part of her total production.¹ Thus the United States can adjust herself more quickly to changes in the pattern of world demand for imports than her European competitors Moreover, in active competition United States producers can, because of the marginal character of exports, offer advantages in price, delivery dates and ancillary services which it is hard for Europe to equal

So far little alleviation of the dollar problem has been secured by exports to third markets This has been in great part due to the fact that there are no countries outside the dollar area who have a dollar surplus, to the bilateral character of world trade, and to dis-

¹ For example, in motor cars the United States exports only 3 to 4 per cent of total production as compared with roughly 60 per cent for the United Kingdom For locomotives the comparison is between 15 per cent in the United States as against 40-50 per cent in the United Kingdom, for textiles 5 to 8 per cent in the United States as against 20-30 per cent in the United Kingdom

advantages which would be removed by the convertibility of major currencies and the establishment of multilateral trade. In view of the foregoing considerations it would seem wise to approach the coming multilateral economy with caution for it will be a very competitive one. The contribution of third market sales to dollar solvency is likely to be a long-term one. Countries with dollar surpluses will emerge outside Europe and if Europe can establish herself in these markets the rewards may be considerable. Europe's aim must be to secure a large share of the new dollars which become available with the secular rise in the United States' demand for imports. The contribution of third market sales to dollar equilibrium may ultimately be a great one, but it provides no immediate alleviation to dollar shortage.

(c) The contribution which limitation of imports can make to dollar solvency is twofold: in a short-term sense direct limitation of imports from the dollar area by quota or embargo serves to keep dollar demand to the inescapable minimum. Such direct discrimination against United States exports is of course contrary to the antipathy and expressed policy of the Americans during and after World War II, but in the face of the extreme dollar shortage of 1945-48 the Americans were forced to admit its necessity. In a long-term sense import limitation must take the form of the development by deficit countries of sources of import supply outside the dollar area. Thus, it forms part of the wider problem of developing a new equilibrium trade structure.

The total imports of Western Europe since the war have been well curtailed and, as a group, Western European countries imported 15 per cent less in 1950 than in the low year of 1938. Even in 1951, with its stimulated stock-piling the fall was 10 per cent. Imports remained relatively stable in 1951, 1952 and 1953. Only in 1954 under the stimulus of rising real incomes and industrial production in Western Europe did imports expand and then not exorbitantly.¹ While thus curtailing total imports Europe has been able to meet the consumption requirements of a larger population and the raw-material needs of an expanded industrial output.²

¹ The ECE index of import volumes for OEEC countries (1950=100) shows 111 in late 1951, 111 in late 1952, 113 in the third quarter of 1953 but 125 in the last quarter of 1953, remaining stable at this level throughout 1954.

² There are several explanations for this. The most important is that the increase in industrial production was initially concentrated in lines, such as engineering, in which the raw material import content is low. A second reason

Table XXIII shows the changes in Western European imports over the war period

When one examines the regional distribution of this import curtailment the result is less satisfying. The fall has been greatest in imports from Eastern Europe, from non-dollar Latin America and from overseas countries outside the Sterling Area and dependent territories. On the other hand imports from the dollar area were only slightly less in 1950 than in 1938 and in 1951 were nearly 30 per cent greater. According to OEEC figures 17.8 per cent of the total imports of the Area in 1955 came from the dollar area compared with 17.0 per cent in 1938. Thus the changes in the sources of Europe's imports have been the opposite of those required, and they have differed considerably from the targets set by OEEC in 1948, at the inception of the European Recovery Programme. The main discrepancies between the import structure aimed at in the OEEC programme and that which resulted were the excess of imports from North and Central America by \$1.5 bln over the target and a shortfall of \$2.7 bln in the aggregate of imports from Eastern Europe, South America and the independent members of the Overseas Sterling Area.

TABLE XXIII
Western European Imports from Other Areas
(*\$ mln at 1948 prices c i f*)

<i>Source</i>	1938	1950	1951
Dollar Area - - -	5,200	4,900	6,700
Overseas Sterling Area - -	4,400	4,300	4,400
Dependent territories (a) -	2,150	2,350	2,200
Non-dollar Latin America -	2,100	1,700	1,400
Other overseas countries -	2,400	1,800	1,800
Eastern Europe - - -	3,150	1,000	850
Total - - -	19,400	16,050	17,350

(a) Other than British dependent territories

Source. 'Economic Survey of Europe Since the War', E C E Geneva 1953. Compiled from table on p. 86

For this failure there are several reasons but one predominates. The persistent dependence on the dollar area lies in changes which

is that economies and substitutions were made in industrial raw materials, and thirdly, there was a fall in the consumption of certain foodstuffs which Europe imports from other areas.

have taken place in the nature of world production and trade — changes, for example, in the source of primary commodity supplies, particularly for bread grains, coarse grains, vegetable oils and fats, and cotton. These are some of Western Europe's most essential imports accounting for about a third of pre-war imports. In each case a very large expansion in their output took place in North America, while there was a great decrease in exportable surpluses elsewhere.¹ A further factor contributing to a high demand for dollar imports has been that in the category of manufactures many of Europe's special demands could, for a time, only be met in the United States. Sometimes it has been shortage of key commodities such as coal and steel, sometimes it has been American equipment required for industrial reconstruction and development, which has increased demand. Much of this import was of course maintained by ERP and is now tailing off. Alternative sources of machinery and capital equipment are now available in Europe and imports of such commodities as coal should cease altogether. These changes in trade structure all merely reflect the economic dominance of the United States which in the last two decades has swept forward and increased beyond all expectations its ability to supply the world with its needs. One cannot predict how long this dominance may be maintained. Other great sources of primary commodity supply may in time be developed but all that is too distant and too uncertain to trouble our calculations. The older sources of industrial products are being renewed and revitalised and will serve in some measure to replace the American manufactures which have been temporarily swollen by reconstruction, but the question of whether we may be able to replace dollar imports by supplies from elsewhere seems to belong to that long run in which 'we are all dead'. Suffice it to say that for at least twenty years the tides of world demand have been flowing towards the United States. There is no reason to suppose that they are yet at the flood.

Until the dollar accounts of deficit countries improve we must persist with direct dollar import controls. It is impossible to assess the contribution which these have made and are making towards alleviating the postwar dollar problem. On one side we must place the curtailment of demand which such discrimination has in-

¹ For a good account of the shifts in world production and trade see *Economic Survey of Europe Since the War*, ECE, Geneva 1953, pp. 13-17.

volved, on the other the increase in dollar imports which ERP has made possible and stimulated. What latent dollar demand may currently exist we can only conjecture. One thing is certain, to remove import restrictions prematurely would be unwise. The proper procedure would be to allow the balance of payments of deficit countries to strengthen, move to equilibrium and, as recovery continues and reserves begin to accumulate, to remove dollar import restrictions progressively.

(d) It has sometimes been argued that the dollar problem can be eliminated by adjusting the relation between the price levels of the United States and her debtors. Basically, it is argued, the problem is a disparity between the supply of and the demand for dollar currency in terms of other currencies and equilibrium between the dollar and non-dollar worlds can thus be established by bringing into the appropriate relationship the cost/price structures of the two currency groups. This implies either a direct worsening of the terms of trade of the non-dollar world by a deflation of prices (and hence of income and employment) in the deficit countries or a depreciation of the rates of exchange of their currencies with the dollar.

Since in any demand and supply situation there is some price capable of clearing the market, it follows that there is some level of the terms of trade which will bring dollar demand and supply relative to other currencies into equilibrium. The exponents of this view do not make clear the process by which they propose to adjust the terms of trade to this hypothetical equilibrium, but, since the argument is usually coupled with condemnation of the inflationary domestic policies followed by some European countries, the inference may be drawn that the adjustment should take place by purposive deflation in these countries. There is a danger here of confusing two distinct issues. It is certainly true that the dollar shortage was in 1945-49 aggravated in Europe by the demand inflations which were tolerated in certain countries. Had such inflations been held in check the dollar crises of 1946-48 would have been less extreme but they would not have been avoided. But it is one thing to say that over-employment and inflation should be purged from an economy, quite another to say that prices and costs should be deflated to some hypothetical level. In order to achieve dollar equilibrium in, say, 1947 such a degree of deflation would have been required in non-dollar countries as would have

created heavy unemployment, abrogated the full employment commitments of governments, and created conditions which would have reacted upon the equilibrium to destroy it. Deflation of this magnitude is not, and has not since the war, been practical politics in Europe. It is almost equally certain that it would have been bad economics.

But there remains the alternative of exchange rate adjustment. Might we not allow the exchange rate between the dollar and the European currencies to depreciate to such an extent as to bring demand for and supply of dollars in terms of other currencies to equality? Thus the mechanism of the foreign exchange market might be invoked for adjustment, whilst avoiding the political and economic repercussions of a series of domestic deflations in deficit countries. There is, it is arguable, always some rate of exchange at which the market will be in equilibrium.

This course of action has a certain superficial attraction, but its adoption is subject to some important qualifications. Let it be said at the outset that in the extreme conditions of dollar shortage which obtained until 1952 this method would have proved no solution. The dollar shortage was in great part due to factors upon which a depreciated rate of exchange would have had little or no influence.¹ Under the payments conditions of 1947 or 1948 a freeing of the sterling-dollar rate would have caused sterling to depreciate to an extent which might have seriously endangered the stability of the British economy. As the rate depreciated import prices would have risen sharply giving a fillip to a domestic price level which was already buoyant under the pressure of inflated demand conditions. The depreciation would have driven prices upward and, in turn, price rises would have impelled fresh depreciation. Confidence in sterling was not great during those years and it is not hard to imagine what the effects of successive currency depreciations might have been. Similar reasoning might have been applied to France, Holland, Germany and most West European countries, at this period. Until the extreme postwar stage of dollar scarcity passed it would have been unwise to introduce into the situation a factor whose curative properties were slight and at best hypothetical, but whose destabilising power was likely to be very great.

¹ For example, the problem of expanding European exports was primarily one of production and procurement. What would have been the use of stimulating, through depreciation, demand for exports which were not available?

With the end of extreme dollar shortage, however, the case for use of the exchange rate as an adjustment device has altered and we must examine it more closely. First, as to timing. Any experiment in sterling convertibility must surely be accompanied by a freeing of the sterling-dollar exchange rate. Such an experiment in itself implies acceptance of the principle of return to the mechanism of the market, but if this is to be feasible there must be some variable through which the international system can adjust itself to the impact of short-term influences. If, as we may assume, full employment policies are still to be pursued, and if we are also to proceed towards a removal of direct restrictions on dollar imports the exchange rate must be set free. We cannot have fixed exchange rates, full employment and trade freedom. We may choose any two but not all three.

The arguments for and against free exchange rates have already been examined¹ and need not detain us further. It was our conclusion that, under normal conditions, an exchange rate free to vary within a range is, on the balance of advantage, the most trouble-free method of adjustment. We must now, however, ask ourselves what contribution, if any, such a rate-system has to make to the alleviation of dollar shortage.

In theory the arguments in favour of a flexible rate on this count alone are not strong. We may assume that, if the dollar problem still obtains, the rates between the dollar and non-dollar currencies would depreciate, thus cheapening European exports to the United States and making American imports more expensive for Europe. The favourable effect which this would have upon the European trade balance with the United States would then be determined by the usual elasticity conditions of demand for imports and exports in the two areas. Such information as we possess upon these is not encouraging. It has been shown² that only for exports of manufactures from Europe to the United States is the price elasticity of demand likely to be high enough to expand sales and the estimate made by Harrod shows that even under the most favourable assumptions the contribution made by a reduction in export selling prices would not be large. This applies with equal force to a depreciation of given magnitude as to a direct reduction of price

¹ Cf. pp. 86-93

² Cf. p. 338

Moreover, in the case of a depreciation there is the added burden of the import price rise for Europe which in some cases, particularly that of the United Kingdom, might be considerable. With the import and export elasticities as they are likely to be, a considerable depreciation might be required before there was any appreciable improvement in the trade balance. In the longer run, however, the effects are more problematic and it might well be that over a period of years there would be significant shifts in demand as a result of a realignment of exchange rates.

The most that can now be said is that some contribution may be made towards an alleviation of the dollar shortage by a depreciation of non-dollar currency exchange rates. The contribution is not likely to be large and in itself depreciation could not be a complete solution. But, if taken in concert with other favourable lines of action, such as a powerful export drive with price reductions coming from increased productivity and from United States tariff reductions it would be beneficial, and is in any event a necessary step towards a freely functioning multilateral economy.

(e) We have seen that during the nineteen-twenties the dollar shortage did not exist because there was then a sufficient volume of long-term American overseas investment to offset the United States external surplus on current account. What alleviation of the present dollar shortage might we expect from a resumption of such investment? There are two aspects of this question: first, what contribution to international long-run payments equilibrium might be made by American long-term investment, and second, what are the prospects that the Americans will in future make such investment? We will deal with these in turn.

When a country has a sustained favourable foreign balance on current account it should, ideally, be prepared to lend its currency abroad and be willing to take servicing and repayment of its capital in the form of an expanding flow of imports. Great Britain in the late-nineteenth century fulfilled these conditions. The position, in the twentieth century, of the United States is fundamentally different and, as has been pointed out (cf. p. 313 above) the behaviour of her foreign balance under the influence of the business cycle is the opposite of that of Great Britain, and certainly not what is required for compensating variations on current account by variations in investment. Quite apart from basic differences of this kind the political climate of the mid-twentieth

century is such as to discourage long-term speculative investment, particularly when, as in the case of the United States, such investment is marginal and competes with abundant domestic outlets for investible funds.

The position of the United States as a well-nigh self-sufficing sub-continent makes it difficult, if not impossible, for her external investment to provide more than a short-term relief to dollar shortage. While large-scale American foreign investment would provide immediate supplies of dollars to the non-dollar world the attendant flow of interest payments and eventually of repayments would place an increasing burden upon the current accounts of debtor countries. In order to close the larger current account deficits caused by servicing and repayment increasing amounts of American investment would be necessary — these in their turn increasing the dollar burden of service and repayment. Unless the flow of overseas investment was accompanied by a steady increase in the United States demand for imports (and other conditions which would render the investment, for balance of payments reasons, unnecessary) it would be impossible for such a flow of investment to continue. One writer¹ has estimated that 'to maintain a rate of net investment sufficient to cover a \$2 billion merchandise export surplus would, after 15 years necessitate such a rapid increase (of United States investment) as to be beyond the bounds of possibility. In 30 years at 4 per cent \$6½ bln would be required, at 5 per cent \$8½ bln. These figures are not and do not include the new investment required to offset amortisation payments. To cover amortisation as well as interest gross United States investment of \$12½–\$15½ bln a year at the end of a thirty-year period would be required if it was maintaining a \$2 bln merchandise export surplus. This is of course inconceivable.'²

While a flow of United States investment sufficient to eliminate the dollar gap is, therefore, impossible and, in some senses, undesirable, a contribution to the dollar problem can nevertheless be made through such investment and every effort should be made to promote this, for economic and non-economic reasons. It is by no means certain that the laws of compound interest would in the event prove so relentless as Mr Gardiner's example implies. The

¹ Cf. 'The Future International Position of the United States as affected by the Fund and Bank', Walter R. Gardner, *Amer Econ Review*, May 1945.

² A sudden cessation of U.S. investment from any cause would result in an insoluble balance of payments problem for the debtor countries.

terms of trade have turned against the United States; they may continue to do so thus reducing the real burden of repayment. Moreover, the decline in United States exports, which has been a feature of recent years, may continue and even if United States imports remain steady there may be a narrowing of the trade gap. It is not suggested that United States investment alone would close the dollar gap, but it could and should make a contribution towards doing so.

As for the prospects of an expanded volume of United States investment, they are not bright. The political uncertainties are many and daunting and the experience of ill-starred American ventures in the 'twenties are still relatively fresh in the American mind. There is no lack of domestic opportunity for investment of private risk capital in the United States and, where the inducements to lend abroad do exist, they lie in Canada and in Latin America — within the dollar area. It seems on present inferences improbable that any considerable flow of American private capital investment will take place in the foreseeable future. For investment from United States government sources more may be hoped. The Truman Point Four Programme provides a basis for a programme of development of backward areas but it should be remembered that the real theme of this programme is technical assistance and skilled advice rather than large dollar loans. Even from such loans as may be made under the programme little general disbursement of dollars may be expected since they are likely to be spent predominantly in the United States on the purchase of capital goods. Nevertheless, it is abundantly clear that the United States regards the development of backward countries as an important part of its policy of Communist containment and, on this, it has shown itself prepared to spend dollars liberally. This facet of United States foreign policy may result in some considerable outflow of official dollars over the next decade. It has been pointed out¹ that it would be a useful stimulus to United States official overseas investment if European countries, and particularly Britain, would achieve surpluses in their balances of payments of sufficient magnitude for them to participate in development programmes side by side with the United States.

(f) The world price of gold is determined by the United States purchase price for the metal (\$35 per ounce) — a price which has

¹ Cf. *The Economist*, November 22, 1952, 'Living with the Dollar', pp. 581-3.

been constant since 1934 and reflects the monopsonistic position of the United States. Clearly any increase in this price would (a) increase the value of gold reserves held by non-dollar countries, and (b) increase the dollar revenue to be derived from sales of newly mined gold.¹ As has been shown² these would be significant contributions to the solution of the dollar problem.

But the problem of the price of gold has much wider significance than that which we have hitherto given it. It involves the whole problem of providing an international unit of account to which national currencies may be related and holdings of which may serve as national liquid reserves for international settlements. Under the international gold standard gold fulfilled this role. As a commodity subject to supply and demand gold came to have a value in relation to other goods and the mechanism of the gold standard ensured that the goods value of the gold stock was adjusted so that it might be adequate to perform its task, which was to provide monetary authorities with reserves large enough to meet fluctuations in their balances of payments. Thus if gold reserves were inadequate deflationary policies would be pursued, prices decline and the goods value of an ounce of gold would rise. In the opposite situation easy credit policy would reduce the goods value of gold. Thus, providing no major scarcity of gold arose, changes in the level of reserves were easily adjustable by some slight deflation.

The first part of the interwar period saw a considerable shortage of gold relative to the level of world trade and this coincided with a reaction in world opinion against deflation as a means of adjusting the goods value of gold. The great fall in prices which took place during the depression between 1929-33 achieved, however, what conscious policy could not, or would not have achieved, a great upvaluing of world gold reserves in terms of goods.³ This great windfall increment of reserves outside the United States was, however, almost completely dissipated by the great gold movements to that country which took place in the late 'thirties and by

¹ A rise in the price of gold would also serve to bring into circulation a part of the \$2,667 mln worth of the metal which, between 1946 and 1951, went into private hoards.

² Cf. pp. 323-4 above.

³ In 1924 the monetary gold supply was 32 per cent of the value of the world's export trade; in 1933 it was 100 per cent. Stocks of monetary gold in central banks and treasuries increased at the rate of 6.3 per cent compound interest between January 1933 and December 1938. Cf. Harrod 'Imbalance of International Payments', IMF Staff Papers, April 1953, p. 3.

the steady rise in prices which began in 1933. By 1955, monetary gold outside the United States was sufficient to meet only 20 per cent of the world's export trade, while the world gold stock was growing only at the rate of 2 per cent per annum. This situation was the combined result of a doubling of dollar prices of all commodities save gold, an increase in the volume of world trade, and the disappearance of an appreciable part of the world's annual gold production into private hoards.¹

In spite of what amounted to a chronic gold shortage the postwar monetary plans retained gold as a monetary unit. But they provided no means of alleviating the shortage other than the augmentation of the existing gold reserves by IMF drawing rights and EPU credits.² If gold was to be truly reinstated as a medium of international liquidity two courses were open to deflate world prices in order to raise the goods value of gold, or for the United States Treasury to raise their official buying price. The first course was completely impracticable. The deflation required would have been massive and would have had to be carried through in the face of other forces all setting in the opposite direction. It was never contemplated by any nation. The second course was also shunned. The gold price in dollar terms has remained fixed. The consequence of this situation is that international liquidity has been inadequate to deal with fluctuations in external balances and in default of adequate reserves countries have been forced to fall back upon direct controls over imports and discrimination against surplus countries.

The present situation is the result of a compromise which is unworkable. The gold standard provided us with international liquidity and a mechanism to adjust national holdings of it. Because these adjustments are unpleasant, socially disturbing and economically deleterious to national economies, we have shunned them, adopted methods of direct control over our trade balances and allowed liquid reserves to dwindle to levels which are inadequate. It must be realised that the corollary of national income stabilisation (particularly if coupled with fixed exchange rates) is a higher and not a lower level of exchange reserves. The provision of

¹ It has been estimated that in 1952 about 65 per cent of total gold production 'disappeared' into private hoards. In 1954 this had declined to some 16 per cent.

² EPU credits should not strictly be regarded as general reserves, since they are available only to finance deficits in certain countries.

such reserves is a *sine qua non* of the sort of international economy postulated in the Bretton Woods Agreement

Much of what has been written in this book is a history of half-hearted attempts to solve this basic problem, dating from the advocacy of the gold exchange standard at the Genoa Conference in 1922 to the Clearing Union Proposal in 1943. But the problem still remains and will some day have to be met. At present, international liquidity of world-wide currency may consist of (a) gold, (b) universally acceptable currencies — at present the dollar, and (c) IMF drawing rights. If the Americans will not consent to raise the price of gold they should be prepared to agree to an expansion of the IMF quotas. To deny both courses of action is either to assert that present reserves of international liquidity are adequate, or to refuse to accept the necessary implications of a multilateral world economy.

So far as the problem is specifically related to dollar shortage, it seems unlikely that the United States will consent to change their dollar price of gold. If that is so, other means must be sought to close the dollar gap. Since the Americans have seen fit to dispense \$38 bln of dollar aid rather than import the gold of the non-dollar world it may be said that they have bought the right to their opinion. That is not to say that their opinion is well founded on economic reasoning, rather it smacks of a certain desire to couple economic policy with the general foreign policy of the United States — a characteristic not new to international affairs.

Economically there is little objection to a revaluation of gold in terms of dollars. The resulting increment in national reserves which, in the period of inflationary pressure, might have intensified inflation, would not be likely under present conditions to have that result. It is true that the relief would be uneven in its incidence, accruing primarily to those countries which produce gold or those which already hold gold reserves, but the gold would be available to be earned by non-dollar countries and under multilateral trade would greatly ease the strain upon the balances of payments of most countries oppressed by dollar shortage.

II

So much for our five lines of attack upon the dollar problem. If the net result is somewhat depressing it is perhaps due to our method of dealing with the solutions singly. It is always easier to

shoot down five successive assaults by individuals, than to repel a mass onslaught by a quintet. It is certainly true that there is no single solution to the dollar problem, but from each possible solution may come such alleviation as, in aggregate, to reduce the problem to less serious dimensions. That is one possibility.

The other possibility is less pleasant. Not all problems have solutions. The dollar problem may be such a one. It may be that the rise of the United States as an economic colossus in the world economy is a force which that economy cannot absorb. The fact that the productive power of the United States increases faster than that of any other country gives some support to this view.¹ If that be so the solution must lie in fields other than the economic and we cannot concern ourselves with them in this book. But we do not take this gloomy view. The resilience of the international economy is great, the magnitude of the dollar shortage is not overwhelming and there is reason to believe that the problem may be soluble. There are ways in which it may be met, and there are factors in its long-run development whose ultimate force may be great. The development of sources of supply outside the dollar area may for example prove in the long-run to be such a factor.² Much of this attack upon the dollar problem must be made by individual countries, but one thing is certain: the dollar problem will more quickly be brought under control if the nations collectively do not adopt a policy of drift. During the postwar phase of extreme dollar shortage disaster was averted by co-operation under the leadership of the United States. Progress towards a complete solution can only come in the same way. If the dollar problem is not collectively attacked the whole conception of the international economy upon which international co-operative effort since Bretton Woods has been based must be abandoned. There will remain a permanent hard core of dollar shortage periodically worsened by relative movements of income in the dollar and non-dollar worlds and held in check at any time only by direct and discriminating import controls.

The immediate task which should be tackled co-operatively by the governments of the great powers is that of providing an ade-

¹ This is in contrast to the British economic supremacy of the nineteenth century when other new industrial powers soon acquired rates of growth of productivity greater than Britain.

² Already there are indications of this in the apparent secular decline in the demand for United States exports.

quate and suitably distributed stock of international liquidity, to form national reserves from which countries may meet fluctuations in their balances of payments. As we have seen the stock of international liquidity is now far below that appropriate to the current volume of world trade¹ and, in a world of incomes stabilised at full employment level, and of fixed exchange rates, it is impossible to proceed as we are doing with reserves so meagre that each balance of payments crisis begets a fresh crop of import restrictions. This problem which was inadequately met at Bretton Woods demands immediate attention, and, although a solution to it is not in itself a solution to the dollar problem, it would create conditions of flexibility in the international economy which would facilitate an attack upon the structural problem of dollar shortage.

There are three ways in which this problem might be met and we shall deal with each briefly. The first and obvious way is for the United States to increase her present buying price for gold, thereby upvaluing existing monetary reserves, stimulating gold production outside the dollar area and bringing gold into circulation out of private hoards. This solution has already been dealt with and, as long as the present United States attitude is maintained, it is not profitable to discuss it further. That avenue is for the moment blocked.

The second approach would be for the member nations to agree to an increase in the quotas of the IMF and to allow member nations automatic access to their quotas on known minimal conditions. This proposal has already been made in Chapter 8 but some further remarks are in order. Let it be said immediately that the increase in the quotas would need to be considerable and par-

¹ The question of what level of reserves may be considered adequate is not easy to answer. Clearly, if we recur to our discussion of Chapter 3, it will have to be large enough to sustain the swings about a fundamentally balanced payments position over the course of three or four years. It will also differ from country to country. Whether the total liquidity in the international economy is or is not at present adequate is a question which would require exhaustive analysis to answer adequately. Briefly, we believe it is not adequate for the following reasons: (1) the major economies of the world (except the U.S.) must at present protect their reserve holdings by direct controls on their balances of payments, (2) the establishment of convertibility of major currencies has been delayed because it is believed that convertibility could not be sustained by existing reserve holdings, and (3) in a world of fixed exchange rates and full-employment-seeking economies the reserve of international liquidity should be high since no mechanism for adjusting balances of payments exists. Readers requiring a full discussion of the adequacy of reserves should consult the IMF paper 'The Adequacy of Monetary Reserves' submitted to the Economic and Social Council of the United Nations in July 1953 and published in *Staff Papers*, vol. III, no. 2.

ticularly so in the case of the United States whose quota would require to be increased by several hundred per cent. This increase should properly be accompanied by more adequate provision for quota revisions as the value of world trade increases. It should not be difficult to work out a method whereby the total of quotas — and hence the addition to international liquidity — should increase with world trade volume in accordance with a sliding scale.

This method of creating additional liquidity would have the advantage over the first method in that it would be possible to distribute the increase in appropriate proportions among the member nations and to hold a continuing influence over the distribution through a system of periodic reviews of quotas. Such a strengthening of the resources of the Fund would have the effect of greatly strengthening its position as an international organisation and would place it, where it in fact ought to be, at the strategic monetary centre of the international economy.

The third approach is the most ambitious and its full implications are too great to be worked out here. It is that every nation should agree to receive payment for its surplus exports in monetary units of account with a Payments Union, such units to be held by its central bank, that these units would be usable to purchase imports in any other country, but that surplus countries should have the option of holding these or of making immediate use of them. This suggestion¹ is in fact that the principle of the payments union which has been pioneered by EPU should be applied on a world-wide scale. As within EPU each member would be given a quota delimiting both its overdraft and its credit to the union. The total of such overdraft facilities in units of account² would then supplement normal payments facilities and the extent of the supplementation would depend on the size of the quotas. As in the case of the Fund quotas the United States quota with the Union would require to be very large, and capable of withstanding two or three years of dollar shortage at the \$2 bln per annum rate.

This approach is superficially attractive, particularly in view of the success of EPU, but on closer inspection it has many snags. An Atlantic Payments Union would be a very much more grandiose affair than EPU and its members would be much less homo-

¹ First made as a proposal for an Atlantic Payments Union in a series of articles entitled 'Living with the Dollar' in *The Economist*, November 22, 1952.

² Which would presumably be defined in terms of gold.

geneous Moreover, it would not have the cohesion which was imparted to EPU by the common problems of Western Europe The United States would be inside the Union and being the largest quota holder would no doubt demand a major voice in control It is hard to see what advantages an Atlantic Payments Union would possess which are not attainable by a strengthening of the Fund, and to attempt this solution would reopen many old questions raised in connection with Keynes's Clearing Union Proposal

The merely technical problem of providing an adequate supply of international liquidity is not difficult, but the political implications, and the fact that all proposals must necessarily hang on the goodwill of the United States, make the implementing of any adequate scheme extremely difficult Inevitably the United States will have to give dollars, inevitably she will impose conditions The process of bargaining is not often such as to lead to ideal economic solutions. For that reason it is perhaps best to approach this problem via the method which is likely to minimise such bargaining and that seems to be via an increase in the quotas of IMF To embark upon an Atlantic Payments Union Proposal would be to open a host of new questions and to revitalise a host of old ones

. SECTION V

'And all her husbandry doth lie on heaps,
Corrupting in its own fertility'

SHAKESPEARE *Henry V*

THE PROBLEM OF INTERNATIONAL ANTI-CYCLICAL MEASURES

IT has been shown in Chapter 2 (ii) how changes in a country's national income are transmitted, via its foreign balance, to other countries of the world economy. At the risk of being repetitive it might be wise at this juncture to outline in less abstract terms the process whereby this transmission of deflation or inflation takes place and what are its consequences.

For full employment to be achieved and maintained in any country total effective demand must equal the value, at current prices, of the national output at full employment.¹ Any deficiency of demand will result in a fall in income and employment, excess in an inflationary gap. Since the total effective demand of any country can be divided into a number of items — personal consumption demand, private investment outlay, government expenditure and the foreign balance — uncompensated variation in one or more of these constituent items will set up disequilibrating income and employment effects. Thus, since the balance of payments is a part of total demand (positive if in surplus, negative if in deficit), its variations are of supreme importance to the level of employment of a country which engages in international trade. Further the force of the multiplier acts upon the balance of payments. Just as an increment (or decrement) in private investment will cause income to rise (or fall) by a multiplied amount, so an increase in the surplus (deficit) in the balance of payments will cause income to rise (fall) by a multiplied amount. Thus the in-

¹ It must not, of course, be supposed from this that we regard 'demand deficiency' as the sole cause of unemployment. It is, however, the main cause in industrial countries, and it is the medium through which the malady is transmitted from country to country. In what follows, therefore, 'full employment may be considered as a situation in which employment cannot be increased by an increase in effective demand.'

come reactions, both to the individual country whose balance has altered and to the rest of the world, are determined by the foreign trade multiplier, which is similar in principle, although more comprehensive in scope, to its simple domestic counterpart

Not only does the balance of payments react upon the level of national income, but income reacts upon the balance of payments. If, for example, there is an autonomous fall in A's national income then A's demand for imports declines and its balance of payments moves favourably. But the reaction of this is felt in other countries trading with A. Their exports to A fall and the resultant deterioration in their balances of payments reacts upon their individual incomes causing them to fall and their imports ultimately to fall also. So the final result is a restoration of international equilibrium for A, and countries trading with A, at lower levels of income and employment for all concerned.

We may say then that when recession occurs in country A it has two effects on the rest of the world B: an income effect when the worsening foreign balance in B deflates B's income, and a liquidity effect when, as a result of its passive foreign balance, B finds itself short of A's currency. The stage at which this liquidity effect becomes important will, of course, be determined by the amount of reserves of A's currency held by B. The nature, force and timing of these two effects depends largely upon the actions which A and B take to meet the recession. For example, A may adopt a deliberate beggar-my-neighbour policy and protect her sagging economy from competition by restricting imports of B's goods. In this case the deflationary impulse initially generated by A will be reinforced for B and B's liquidity problem will be intensified. Either on her own initiative, or in retaliation for A's action, B may discriminate against imports from A. This will intensify the recession for A. It may relieve B's liquidity problem temporarily but it will not halt the decline in its income generated by the recession in A.¹ The further fall in A's exports will only serve to deepen depression in that country, and thus lower its imports

¹ If we imagine B to be one country (and not the rest of the world external to A) then distinction must be made between import controls by B which are discriminatory against A and general control on all imports into B. If only discriminatory import controls are imposed by B the secondary deflationary effect is confined to A. If, however, the import controls are general there is a widening of the deflationary effect to all countries who export to B. In this way the recession which had its origin in A could be transmitted to the whole world economy.

from B still further with deflationary results. If B takes domestic counter-measures against recession and tries to raise its own income level it will have to (a) be prepared to run a passive balance of payments with A until the recession in A is at an end, or (b) seek to minimise the passive balance by using discriminatory import controls against A's goods. The best situation will be if neither A nor B controls imports from the other, but each takes fiscal and monetary measures to curb the recession, meeting the balance of payments disequilibria by transfers to A from B's reserves. This of course assumes that there is a sufficiency of such reserves. Inadequate reserve holdings will certainly invoke discriminatory controls by the deficit country against imports from the surplus country. Where depression is transmitted to the world economy from one country the incentive to restore international equilibrium comes primarily from the desire to restore full employment and only secondarily from a wish to restore balances of payments, although that may be regarded as a useful secondary result. For this reason counter-measures against unemployment will be taken both in the deficit and surplus countries as soon as the disequilibrium arises. But it is clear that such counter-measures should be mutually agreed upon. Unilateral defence against externally propagated depression is likely to lead to national economic rivalry, to measure and counter-measure, whose ultimate results will be detrimental to all.

The process of income transmission can easily be applied in reverse to the case of an inflationary stimulus bred of inflation in A and a rise in A's imports from the rest of the world B. Now income in B will rise as its exports to A increase. A's foreign balance will become passive, that of B will be active.

It may be that the liquidity effect will invoke counter-measures by the government of A and thus halt the inflation. A will soon exhaust her reserves of B's currency and she must then either control her imports or deflate her economy. In some cases both steps may be necessary. As long as reserves of international liquidity hold out there may be a tendency for A's government to let boom continue in A. Inflation, if mild, may be tolerable and may go some way unchecked. In B, with a favourable foreign balance and a rising income there is no incentive to take action against the inflation—rather the reverse. Thus inflation throws the burden of readjustment on to one country which may be slow to take action.

From all this certain important facts emerge (1) fluctuations in the income of a country engaging in international trade are important for every other country in the world economy, since the inflationary or deflationary impulses emanating from one country are generalised throughout that economy (2) Contra-cyclical action, to have the maximum effect, must be co-ordinated, so as to operate in both surplus and deficit countries (3) The effects of income fluctuations upon balances of payments are such as demand a large and appropriately distributed holding of international liquidity in the international economy (4) Failure to co-ordinate national anti-cyclical policies and/or inadequacy of international liquidity makes the periodic adoption, indeed the perpetuation, of discriminatory import controls inevitable

It is clear that, in the international field as in the domestic, a high and stable level of employment can only be maintained by conscious planning. In the words of a United Nations report 'the objective of full employment policy in its international aspects is to create conditions under which any particular country will so behave in its international economic relations as not to prevent other countries from maintaining the stability and prosperity of their economies'

The necessity of planned international action in the field of contra-cyclical policy is the more apparent if we consider how vulnerable is the world economy in its present state. The United States, as the largest creditor nation, must necessarily import on a large scale if the dollar is not to remain permanently scarce. Any decline in United States income must cause a decline in her imports. This reacts upon the non-dollar world in two ways. In the first place, exports to the United States, particularly exports of manufactured goods of high quality, decline sharply with the fall in United States income, with attendant deflationary income and employment effects in the exporting countries. In the second place, the balance of payments of non-dollar countries with the United States worsens and the dollar shortage is thereby made more acute. With reserves of dollars at such low levels as at present obtain the only course open to most countries is to intensify their discriminatory controls against imports from the United States.

The general picture is gloomy: closer scrutiny does not improve the prospect. Consider the position of the United Kingdom in the face of American recession. Initially, United Kingdom exports to

the United States, which are mainly manufactured goods of high quality for which the American demand is sensitive to income changes, will decline and British industries supplying these goods will suffer recession. Meanwhile, Sterling Area countries exporting primary commodities to the United States will suffer a decline in the demand for their products and may be forced to curtail their buying of United Kingdom manufactured exports. As a result of both these influences the British export industries would experience a recession which would be quickly transmitted to the whole economy. Although domestic counter-measures might do something towards mitigating such a decline, it is almost certain that they could not prevent a considerable measure of unemployment. Export industries in Britain are not only large but several are localised, and such unemployment would provide a particularly difficult problem to meet by the generally accepted anti-depression measures.

Equally embarrassing is Britain's position in conditions of world inflation. In present circumstances inflation means sharp rises in the prices of primary products. As these are Britain's main imports, and as their prices rise more swiftly than those of manufactures, the result is a deterioration in Britain's terms of trade — a deterioration which may be sufficient to place her balance of payments in deficit. Thus from both movements in the cyclical process Britain stands to lose heavily.

The instability of the world economy at present consists in three main features. First, there is the sensitivity of United States import demand to fluctuations in American national income. This ensures that even slight variations of American income communicate themselves quickly to other countries. Second, there is the existence of structural dollar shortage which is greatly and quickly intensified by any decline in United States imports, and forces an immediate liquidity problem upon deficit countries. And third, there is the susceptibility of the United States to income fluctuations which makes the recurrence of such crises a constant danger.

Such is the nature of the problem. What, we may ask, are the international measures appropriate to meet these elements of instability?

Any plan for the preservation of international full employment clearly must do four things:

It must ensure that each nation has a programme of domestic measures to maintain full employment and that the level of employment defined as full should be known and stated so that the time and method of counter-measures against recession should be known and understood by other countries, -

It must establish effective machinery for the preservation and restoration of international equilibrium,

It must insulate individual economies against income changes generated through the balance of payments, and

It must stabilise the flow of international investment over long periods

The international approach to the problem since the war has been sound in principle, but the scale of attack has been insufficient. All of the governments of the major industrial economies are committed to pursue full employment policies, and, although the details of such policies and the measures to be pursued are somewhat vague, there is little doubt of the sincerity of purpose and of the ability of governments to pursue this aim more or less effectively. Machinery intended for the preservation of international equilibrium exists in the IMF, and that for assisting investment in the IBRD, but there is not as yet any agreed means of insulating individual economies from income effects via their balances of payments. The imperfection of our existing international machinery to meet the needs of a full-blooded international full-employment scheme is in fact due to the difference between the conception of the mechanism of international monetary control as it was in 1944-45, and the reality as it exists today. The structure is by reference to the prime conception incomplete, partly because the provision of additional liquidity by the IMF is insufficient in amount, partly because institutions like ITO were never brought into being, and partly because employment planning, coming late in the agenda for attention among the powers, was discussed in an atmosphere less conducive to agreement than that of 1944, and became bogged down in endless negotiations, proposals and counter-proposals. In this bog it still remains.

It is not surprising that the other aspect of anti-cyclical planning — measures for the control of inflation — has been even more sterile in result. With the experience of the interwar period in mind economists and statesmen at Bretton Woods and in the Economic and Social Council of the United Nations have thought

mainly of how the world economy may be protected from the effects of recessions in the income and employment of the United States. Inflation seemed to be a remote possibility, and, even if it came, its international effects would be less dire, while the burden of adjustment would fall upon the country in which the inflation had its origin. As for the other countries they would benefit from an active balance and stimulated trade. In due time the inflated economy would be forced, for liquidity reasons, to control the inflation and all would be well.

Now, being wise after the event, it is apparent that too little attention has been paid to the problem of transmitted inflation. With all of the major countries committed to the preservation of full employment and having exaggerated fears of the onset of post-war depression, with the demand pressures of capital reconstruction, social outlay, and later of rearmament plans, inflation has been the perennial, national and international, postwar problem. The economic motives invoked by inflation have played their part. Countries experiencing demand inflation have, on several occasions, been prepared to let inflation rip, so long as reserves of international liquidity held out, or credit was available, mitigating its effects meanwhile by excessive imports to add to their own production and meet the excessive demand. These motives would become more powerful if, in accordance with measures for international full employment, world holdings of international liquidity were increased. The one incentive for inflating countries to disinflate would then be removed and inflation might be allowed to proceed in country A until B was also suffering severe inflation. The greater the stock of international liquidity commanded by the nations the more necessary it becomes to provide what one writer calls 'international rules of the game to check the "export" of inflation'.¹ There is need to regard co-ordination of national anti-inflationary policies as a corollary of anti-depression measures. It may well be that both are equally important for the future.

¹ Cf. Brian Tew, *International Monetary Co-operation* (Third Edition), London 1956, p. 65.

INTERNATIONAL ANTI-CYCLICAL
PLANS

I

WE must now consider what steps have been taken for the promotion of international full-employment and to prevent the spread of depressions from one country to another. The importance of full-employment policies for the efficient working of the international economy, and as a precondition of convertible currencies and multilateral trade, was recognised in the Fund Agreement, the Havana Charter and the United Nations Charter. In all these documents, however, full employment was recognised only as a general aim of all international economic co-operation and no specific provisions were made for its attainment and preservation.¹ The Fund, it is true, had a useful contribution to make to this policy aim, but it was ancillary rather than central to the Fund's work and purposes. It was not until 1949 that it fell to the United Nations to propose specific plans for the purpose of securing and preserving international full employment. Our task falls therefore, into two parts: first it will be necessary to examine the contribution made by certain established institutions, and then we must consider plans which have been formulated, but never implemented, for more elaborate anti-cyclical arrangements.

The conditions which an adequate international anti-depression

¹ There was some discussion in Washington in September 1943 on the topic of international full employment. It was, however, felt that international full employment was not an objective for which a special agency should be responsible. There was no special set of measures which would secure full employment which depended more upon the success of all separate measures for monetary and commercial planning. What was required was a special co-ordinating body which would watch the activities of all the special agencies with this object in mind. The matter should be referred to those who would be responsible for the general organisation of the United Nations. This was subsequently done. Cf. R. F. Harrod, *Life of John Maynard Keynes*, p. 568.

policy must satisfy have already been set down. With the first of these we cannot deal here. It is the declared policy of the governments of the great economies that they will seek to preserve full employment. All have strong incentives for doing so in the watchful eyes of their electorates and for reason of self-preservation, if for no other, their sincerity is not in doubt. The precise measures by which depression would be met in their economies are not set out by either the United States or Great Britain. We must assume that these would be appropriate to the severity, timing and source of the recession. In both countries there is evidence that the techniques of budgetary control and monetary policy are well understood and there is reason to believe that they would be used intelligently in the event of need. Of the ability and purpose of some of the smaller economies one is less sure, but the influence of these economies on the world economy is not great. In the main it is fairly certain that, at the first sign of depression in their economies, the governments of the great powers will take effective domestic counteraction. It would be helpful if at frequent intervals governments compared notes as to the standards of full employment which they hold and the measures they propose to use. It is probable that in some cases, as between Britain and the United States, this is already done informally. For an exchange of views on such matters use can be made of the annual meetings of the IMF and IBRD in September of each year.

The second condition of an international anti-depression policy, that of the existence of effective machinery for the preservation and restoration of international equilibrium, is met, in part, by the existence of the IMF. In so far as the Fund is prepared to advance a scarce currency to deficit countries after the onset of recession in a surplus country the Fund is providing international liquidity and postponing the time when the deficit countries must take discriminatory action to exclude the exports of the surplus country from their economies. This is a positive contribution by the Fund which is, however, limited by its willingness and ability to supply the scarce currency. A major depression in a creditor country such as the United States would threaten the stability of the Fund, which, in face of sustained demands for the scarce currency, would have no option but to declare it scarce and permit discriminatory restrictions by members against the exports of the depressed surplus country. Clearly a major recession in the United States would

imperil the Fund, causing a payments crisis as it became unable to supply dollars to deficit countries. It is essential that the Fund's holdings of potentially scarce currencies should be increased so that this contingency may be met, if and when it arises. Suggestions to this end have already been made¹ with the requirements of international anti-depression policies in view.

But something further is required of the IMF. It must provide a means of balance of payments adjustment as well as liquid reserves. This aspect of the Fund has already been dealt with but its relevance to the present problem should be noted. If international adjustment is to take place it must be through (a) changes in the relative price and income levels of the deficit and surplus countries, (b) through appropriate changes in the exchange rates of the countries concerned or (c), through direct interference by governments with the balance of payments via import controls. The architects of the Fund precluded the use of these expedients and, devoid of any appropriate mechanism, it remains unsuited to fulfil the function of adjustment. We have already argued, and the present argument that anti-depression policy requires an adequate adjustment mechanism reinforces our earlier argument, that it is to flexible exchange rates that the Fund must turn in order to fulfil this function adequately.

Like the Fund the IBRD is in a position to make a powerful contribution towards the eradication of world cyclical movements. Past experience of international investment points to two major defects: firstly, overseas investment, when in private hands, tends to be unstable, often ceasing in periods of depression when it is most needed, and secondly, underdeveloped countries are often loth to admit foreign capital for political reasons. If international investment is to contribute towards a structural equilibrium in world trade, and to provide for the effective development of backward countries, it will have to be motivated by a conscious policy. Such a policy should aim at stabilising overseas investment over long periods and at overcoming the reluctance of borrowing countries by interposing an international organisation between lender and borrower. Such an organisation is already in being in the IBRD but, for the efficient organisation of foreign lending, the Bank has certain defects which must be corrected. These defects are two. In

¹ Cf pp 215 and 357 above

the first place, the Bank's resources are too small to furnish such a long-term investment programme as is required, and secondly, the Bank is only permitted to lend for specific and approved projects. The Bank, however, like the Fund, provides a basis upon which a satisfactory structure may be built and proposals for its extension have been made by a United Nations Committee.

The framework for an international full-employment programme was, then, already in being, and in 1949 a number of constructive suggestions were made whereby the framework could be utilised more effectively. In December 1949, a committee of experts, charged by the United Nations with the task of proposing measures for the domestic and international control of employment, reported to the Economic and Social Council.¹ The section of this Report relating to international measures for full employment was by far the most ambitious set of proposals which has been made for this purpose and for that reason it is worth pausing to consider the scheme in some detail. So far as possible the experts considered it wise to work through already existing institutions. Facing the deficiencies of the Fund squarely they proposed to eradicate them by adding to its powers and functions. The principle of the Fund — that of reinforcing the gold and currency reserves of members by drawing rights on a central currency pool — was sound, but the Fund was not large enough to stand up to a prolonged drain. If countries had at their command adequate currency reserves upon which to draw when their exports declined and balances of payments became passive, then there was no reason why depression in a large importing country should threaten the liquidity of its debtors. Deficit countries would meet their adverse balances by drawings on reserves while at the same time taking domestic action to replace the fall in foreign demand for their products by appropriate increases in domestic demand. The depression would be sealed off in the country of its origin, there to be attacked with appropriate monetary and fiscal weapons. But for this, large and well-distributed reserves would be necessary and the existing low level of currency reserves in all non-dollar countries ensured that a fall in exports to the United States would be quickly followed by intensified import restrictions — as was the case in July 1949. It was this paucity of reserves which made contraction in world trade

¹ Cf. *National and International Measures for Full Employment* United Nations, New York, 1949.

general, and it was this defect of the Fund that the scheme outlined in the United Nations Report sought to eradicate

The Report recommended that the Articles of Agreement of the IMF should be extended so that it might operate the scheme in addition to its other functions. The main provisions of the scheme were as follows

(i) If any country becomes depressed as a result of a fall in internal demand so that the value of its imports falls, and the decline is not fully offset by a concurrent decline in the value of its exports, then that country (which we may call the 'depositor country') should deposit with the IMF an amount of its own currency equal to the fall in its imports less any fall in its exports for the given year as compared with a reference year. The deposits should be made at annual intervals and not later than six months from the beginning of each calendar year

(ii) The reference year should normally be the last year in which the depositor country achieved its full-employment target

(iii) The IMF may waive the above deposit obligation if the country concerned is able to show that the decline in its demand for imports is not due to a fall off in internal demand

(iv) The IMF should have the right to sell the currency of the depositor country against the currencies of other countries. The purchasing countries should be entitled to buy the currency of a depositor country in an amount not exceeding the value of the fall in their exports to, less the fall in the value of their imports from, the depositor country as compared with the base year. Applications for the currency of the depositor country should be made to the IMF not later than August 31 in each year, and any balance remaining after all claims have been dealt with should be refunded to the depositor country as soon as possible

(v) The currencies of purchasing countries received by the IMF are to be placed to the credit of the depositor country concerned, and to be available for the finance of current transactions by that country in subsequent periods, to the extent to which its own monetary reserves are diminishing

(vi) The depositor country should maintain the value of its deposit with the IMF for any changes in the par value of its currency

(vii) All the above transactions of the IMF to be operated separately from its other transactions

The authors claimed that these arrangements would augment national currency reserves, and prevent deflationary pressure caused by depression in a great importing country from becoming general, that it would strengthen the IMF without either raising members' quotas or redistributing the world's gold stock; and that, by basing deposits with the Fund on the import and export figures for the previous year, it would allow for the continuous growth of international trade, in contrast to the original system of IMF quotas, which fixed the resources of the Fund once and for all. Lastly, it would provide for deposits for surplus countries only when the social costs of such deposits are negative, namely, when they serve to maintain the volume of the depositor's exports.

This scheme was largely automatic. For that reason it was simple and could not hope to anticipate all the exigencies with which, in practice, it would have had to deal. It was, like that part of the Report which was devoted to domestic measures for employment stabilisation, Keynesian in approach, its main principle being the maintenance of foreign demand by an assured supply of foreign purchasing power. For that reason it gave, as domestic plans for the maintenance of effective demand have so often given, a spurious appearance of infallible simplicity. If aggregative planning has a besetting sin it is that it conceals much that is important and complex behind its simple aggregative equations. The plan partook to some extent of this defect.

The main danger to the achievement of international full employment through the plan lay in the assumption that deficit countries would make immediate use of the purchasing power which was made available. Clearly much depended upon circumstances and upon the types of economy of the deficit countries concerned. There was also the danger that it would be impossible in practice to break through the now accepted and established method of import restriction, and obtain that high degree of co-operation and acceptance of the 'rules of the game', without which this or any other scheme must necessarily perish.

The scheme was not implemented. It is now of only historic interest and it is pointless to examine it exhaustively, yet one point of criticism is worth making. The scheme should have had a shorter accounting period than one year. This would have given it greater flexibility and ensured more timely support to deficit countries without exhausting their own currency reserves. The

scheme aimed at reinforcement of national currency reserves but it could only have achieved this if it had operated quickly enough to keep national reserves in being. When we consider that between April 1, 1949 and September 30, 1949, the Sterling Area gold and dollar reserves fell from \$1,856 mln to \$1,425 mln — a decline of 23 per cent — it is not hard to visualise how a more severe recession than that of 1949 could have exhausted the reserves completely before help was forthcoming from the Fund.

The scheme provided also for the stabilisation of long-term overseas investment and, for that purpose, it advocated certain modifications in the constitution of the IBRD. There were, it was argued, two defects in the Bank's working which had to be eradicated. In the first place, the Bank's resources were too small to furnish a long-term investment programme of the magnitude required; and in the second, the Bank was only permitted to lend for specific and approved projects. The Report proposed that governments of lending countries should take direct responsibility for a large volume of future overseas investment, the amount of which should be declared in advance. Having established targets for future investment, lending governments should, every six months, place at the disposal of the World Bank an amount equal to the total overseas investment planned for the period, less the amount which it was expected would be lent by private investors. If the amounts lent by private enterprise fell short of (or exceeded) the expected level, the government payment to the Bank was to be adjusted accordingly in subsequent periods. The Bank should allocate loans to applicants, from the pool of its lendable resources, on the merits of the development schemes put forward — investigating programmes and following their execution. Loans should be granted for general development purposes as well as for specific projects, and such loans should be available for the financing of any imports directly or indirectly necessary for the execution of the programme. The stimulus which such a scheme as this would give to international investment and the development of backward regions would it was argued, be considerable and it would also permit overseas lending to fulfil its secondary role, as a force making for equilibrium in international trade. Moreover, the scheme had the advantage that it built upon the basis of an existing institution, and would thus have been more easily implemented than if all the institutional machinery had to be innovated.

The schemes put forward in the United Nations Report, had they been implemented, would have represented a new stage in international economic planning. Not only did these proposals constitute the most important contributions since the publication in 1943 of the Keynes and White Plans, but they contained proposals which might have gone far to eliminate some of the defects which experience had revealed in the Bretton Woods institutions. In its proposed new role the IMF would have acquired new significance, not only through its additional functions but ultimately in the rôle for which it was intended. The Bank, too, would have been greatly strengthened. But such things were not to be. It was impossible to ignore the fact that, in considering the plan, the United States had to be regarded as the potential 'depositor country' and that, perhaps for years to come, periodic payments would, under the scheme, have to be made to the Fund by the United States. In 1949 and 1950 the ERP was at its height and it is not to be wondered that the United States saw in the scheme another means whereby the non-dollar world might extract dollar aid from her. The measures of the 1949 Report did not commend themselves to the Economic and Social Council of the United Nations as either acceptable or practical and it was directed in August 1950 that 'a further group of experts should formulate and analyse "alternative practical ways" of dealing with the problem of reducing the international impact of recession'.

The new team envisaged its task as one of suggesting policies and practical conditions for their implementation, rather than one of drawing up elaborate schemes for formal and automatic international payments devices. This gave to its Report (*Measures for International Economic Stability*) a refreshing sense of realism, showing that its authors were clearly aware that economic planning, like politics, is the art of the possible. The Report was based on the assumption that threats to international full employment can develop along three lines: through fluctuations in the prices of primary products acting upon the terms of trade; through sudden and unforeseen variations in the level of overseas investment; or by countries possessing such meagre international monetary reserves that maladjustment of their balances of payments necessitates the taking of action inimical to national or international prosperity. Although these three causes do not exhaust the possible sources of international economic instability (changes in the forces generating

demand and supply of internationally traded commodities, in taste and technique, in the emergence of new products or in crop variations must also be considered) a solution of the problems which they create would take us as far in the direction of planned stability as we are ever likely to get. The problem then resolves itself into one of stabilising international prices, of ensuring a steady flow of international capital, and of placing adequate international monetary reserves at the command of individual countries.

The experts' measures for dealing with international prices and overseas investment need not detain us long. The problem of short-run fluctuations in the prices of primary commodities was to be met by the negotiation of international commodity agreements aimed at equating international demand and supply. The nature of these agreements was, of course, to differ according to the nature of the product, but long-term contracts, quota systems or buffer-stock schemes, either separately or in combination, were to be the basis of such schemes. In this, as in its other recommendations, the Report advocated the use of already existing organisations (such as the International Materials Conference) to co-ordinate structure and policy among the various schemes. International investment was to be stabilised through the agency of the IBRD whose powers and scope might be extended for the purpose.¹

It was the Report's plans for the provision of monetary reserves through the IMF which were most interesting and far reaching. It suggested that certain changes be made in the Fund's Articles, both to make its working swifter and more flexible and to increase its currency resources. It was argued that, even if the latter should not prove possible for political reasons, the former aim should still be sought by easing the conditions under which currencies are supplied to members. If it were agreed to waive the rule whereby a member may not, in a given year, purchase currencies to a value greater than 25 per cent of its quota; if in appropriate cases the Fund should be prepared to waive the rule that its holdings of a member's currency should not exceed 200 per cent of its quota; and if sales of currencies were made freely and quickly, but under stricter contractual arrangements for repurchase than now exist,

¹ More specifically it was suggested that the Bank should be prepared to extend its lending in recession both in long-term investment and in the financing of buffer stocks. For this purpose it was proposed that the Bank's capital should be increased and that the proportion of capital available for loans should be greater.

the Fund would be in a stronger position to assist its members to tide over temporary external deficits without their resorting to restrictive measures.

As for the Fund's total currency resources, the Report grasped the nettle firmly by calling for an all-round increase in quotas. This increase was not to be proportional to the existing quotas, but was to be based upon a new assessment of members' needs. Obviously the quota of the United States would require to be substantially increased and since the quota is a 'once-for-all' subscription, an increase of the order of 100 per cent might be necessary. If, for example, the United States' quota was increased from \$2,750 mln to \$5,500 mln, the latter figure would, even at the abnormal 1947 rate of dollar sales, give about ten years' supply. Given firm repurchase requirements and freedom from extreme depression of the pre-war type, this should provide an adequate source of dollars for member states. The Report realised that there were practical difficulties in the way of securing a prompt and sufficient increase in the Fund's resources by this means¹ and it provided for alternatives. The liquid reserves of all member countries might be increased proportionally by a uniform change in the gold parities of all countries or the Fund might borrow from the United States and act as an agency, relending dollars to its members. Of these two alternatives the Report favoured the latter. At the time when it was published² a uniform increase in liquid reserves brought about by an increase in the dollar value of gold appeared to be a course fraught with peril. In a world threatened by inflation could one be sure that wisdom and credit policy would be capable of preventing any considerable increase in national reserves from increasing the amount of national money and forcing up prices? Moreover, it seemed likely that the United States would not favour this course, inasmuch as that country had consistently opposed revision of the price of gold, which a uniform change of gold parities would of course involve. As for the latter course it seemed that in the event of recession in the United States that country would probably be liberal in lending its currency to the Fund as a means of preventing unemployment in its exporting

¹ The difficulties were (a) whether the United States could be induced to make such a large payment to the Fund, and (b) how adjustment to the voting power on the Board of Governors could be adjusted to the new situation without giving the United States absolute control of the Fund.

² November 1951, during the post-Korea inflation.

industries and of reducing the need for other countries to discriminate against its exports.

There is no doubt that the second United Nations Report was, if less ingenious and far reaching, nearer to the political realities than its predecessor. Its proposals were modest and attainable. Moreover, they were aimed also at giving new life to the Fund and of bringing it to its rightful place at the centre of international payments policy. Had they been adopted they would not only have been a valuable defence against the international spread of recession but they would have given new life to the whole Bretton Woods system and enabled it to play the part for which it was originally intended. They were not adopted. Like its predecessor this United Nations Report was quietly set aside.

Here the major co-operative efforts to set up international measures for the preservation of full employment ended. Of planning there has been plenty and it has been of a high order, but clearly there must come a time when planning passes from the study to the Cabinet Room and the legislature. It is, even now, somewhat sobering to reflect upon what flimsy arrangements — a handful of generalities, promises and pious hopes — the great powers base their hopes of full employment. In the international field we have only the Fund and the experience of ten postwar years which show that, if depression comes to one of the great economies, only prompt and pre-determined action will prevent it spreading and becoming general.

II

While there have been plans in plenty to deal with the international transmission of depression there has been scant attention to the companion problem of the transmission of inflation. This neglect is understandable. In the interwar period our experience was all of the first evil and, although high levels of employment have been preserved in all of the major economies since the war, the international effects of such small declines in American national income as have occurred have made us conscious of the instability of the world economy and fearful of the results which may attend a major depression in the United States. An equal reason for such neglect is, however, that inflation in a single country of the world economy has by its income effect a beneficial influence on the income and employment of other countries. Their balances of pay-

ments are strengthened. Only if they are already themselves fully or over-employed is the stimulus from abroad likely to be destabilising. Why not then leave it to the inflation country to treat its inflation by domestic measures as soon as shortage of liquid reserves forces it to do so?

There are two reasons why international anti-inflation measures may be useful. The first is that the major economies are now pursuing full-employment programmes; that, in addition to these programmes, the demands of capital investment, social services and defence press upon limited national resources and have made, since the war and may for long continue to make, the great economies hover on the border of demand inflation. In such circumstances further stimulus through the balance of payments is certain to intensify inflation. If, as has so often been advocated both in this book and elsewhere, national reserves of international liquidity were to be supplemented, either by allowing nations to have automatic access to either an augmented IMF or by some other means, the incentive for countries to take counter measures against inflation would be removed and it would be all too easy for countries to relieve the worst effects of domestic inflation by allowing large deficits in their external balances to continue indefinitely. Even in 1944 critics of the Bretton Woods proposals were not slow to see this possibility in the Fund mechanism. Experience has given weight to their words.

There is no way of dealing with this particular problem of transmitted inflation other than by an internationally agreed code of behaviour among governments. To give the IMF its due it has consistently recognised this need and has, through its annual reports and by other means, called the attention of members to the need for disinflationary measures when it seemed that these were an appropriate means of dealing with their external disequilibria. It is best to be realistic in this matter. As long as national governments may pursue policies which are to their own liking, and the liking of their electorate, without incurring penalties they will do so. It is pointless to talk of an internationally agreed code of behaviour for nations in controlling inflation unless that code can be enforced by sanctions. The only effective sanction in the hands of such a body as the Fund is to increase ruthlessly the interest charges for the loan of currencies to a member who is deliberately allowing inflation to continue and using an external deficit to

ameliorate the effects of that inflation. Both theory and experience indicate that unless some such sanction is applied the liquidity which the Fund advances will be used for unilateral reasons. It may be argued that in such cases the Fund should deny the use of its resources completely to the member as it has power to do under Article V (sec. 5) of its Articles. This might be an effective sanction but it would destroy the automatic use of the Fund's resources which has been advocated in Chapter 7. It seems preferable that the Fund should, like a central bank, use its penal interest rate to force anti-inflationary adjustment upon the offender.

The second reason for anti-inflationary policies is equally powerful and has been widely recognised. It springs from the fact that inflation may be transmitted from country to country via the price mechanism as well as by income effects. For many of the great industrial economies primary products are the main form of import and, for a variety of reasons, these are subject to wide price fluctuations. Most producers like to keep their stocks of raw materials in fixed relation to their output and this often leads to variations in demand greater than those in consumption. Then there are speculative changes in stocks of such products which in turn tend to aggravate normal fluctuations in demand. Lastly, the inelastic nature of the supply of most primary commodities ensures that changes in demand lead to great changes in price. In the postwar period the markets for primary commodities such as jute, cotton, wool, rubber and non-ferrous metals have often fluctuated violently and with unstabilising results for the economies of the great importers. In the case of a country such as Britain, whose demand for raw materials and foodstuffs is large and inelastic, a rise in primary-commodity prices is quickly transmitted via raw material costs to domestic prices. Cost inflation is exacerbated by wage demands and the rise in prices which results is one which normal counter-inflationary weapons, either monetary or fiscal, are powerless to stop. In 1951, when the wave of panic primary-product stock-piling turned the terms of trade sharply against Great Britain, the government of the day was powerless to prevent the domestic inflation from running its course and the change in the terms of trade had well-nigh disastrous effects on the British balance of payments.

Yet another destabilising effect of primary-product price fluctuations occurs when such prices fall thus reducing the export pro-

ceeds of the primary producing countries, reducing their incomes and thereby their demand for the exports of industrial countries. Such a fall in primary producers' incomes may be caused by a quite minor decline in production and employment in the industrial countries which is sufficient to bring a large decline in the export proceeds of the primary producing countries. In the past this has, on occasions, led to unemployment in both countries. Changes in the demand for and supply of primary products thus raise problems both for primary-producing and for industrial countries. They aggravate the problem of maintaining an easy balance between the various parts of the international economy and of restoring multilateral trade and payments. Since much of the imports of the United States consists of primary products, so dollar proceeds from this source are subject to fluctuation, and balance between the United States and the rest of the world is thus made precarious.

These are but a few of the most deleterious effects which can flow from price fluctuations of this type. Others might be listed. Clearly it is desirable to deal with these at the source by instituting arrangements for the stabilisation of primary commodity prices.

This is an old story. International commodity control schemes have been advocated and attempted for many years with a bleak record of failure. Is there reason to suppose that they would be more successful now? The authors of the United Nations Report on *Measures for International Economic Stability* believed so and they argued that the time was ripe for a fresh effort.¹ This optimism was founded on the fact that an essential condition of success is now satisfied for the first time. This lies in the fact that the great economies are now pledged to avoid fluctuations in their domestic economic activity; that it is a reasonable assumption that large-scale world depression will be avoided and that 'for the foreseeable future, there will be an upward movement in production of all kinds throughout the world, interrupted only by relatively minor setbacks'. The long-term trend of prices is more likely to be upward than downward and disastrous falls, such as that of the 1930's, will be avoided. This view, the Report argued, is widely held and thus one of the main obstacles to commodity control schemes has been overcome. Widespread fear of depression prevents importing countries from entering into long-term commitments through

¹ *op. cit.*, p. 19.

buffer-stock schemes to buy specified quantities at agreed prices for any considerable period ahead and, without the collaboration of the great buying countries, it is impossible for the producers to institute effective price stabilisation arrangements. Thus, in new found confidence the major impediment to primary-product control schemes is removed. The committee also derived encouragement from a number of agreements aiming at stability which have been reached since the war, in particular the International Wheat Agreement and the long-term contracts made by the United Kingdom.

It is no part of our task to describe or analyse the various possible types of commodity agreements. These must be worked out and implemented by the governments of the countries concerned, for they will necessarily differ from commodity to commodity and will be conditioned by circumstances. The temptation to create some new supra-national authority with vague co-ordinating powers must be resisted. There is already adequate provision — in such bodies as the International Materials Conference — for this purpose.¹ It should be the object of these bodies and of the IMF to encourage the establishment of adequate international price stabilisation plans. These are as essential a part of a stable international economy as plans for full employment. It may well be that, in the economic climate of the world as it is at present, they will be even more useful.

¹ The whole question of primary-commodity stabilisation schemes and their significance for economic development was reviewed by an *ad hoc* United Nations Committee. Cf. *Commodity Trade and Economic Development*, United Nations, November, 1953.

CHAPTER 15

CONCLUSION

'I understand a good many things as I didn't understand before; but whether it was worth while going through so much to learn so little, as the charity boy said when he got to the end of the alphabet, is a matter of taste.'

Sam Weller in *Pickwick Papers*

THE present is an opportune time to look out upon the international economy and take stock. After the confusion wrought by the war the dust is at last settling and it is possible both to adjudge what has been taking place and to discern, somewhat dimly, what may be to come. This book has been concerned with what has been done to bring order into international monetary affairs during the past decade; it is perhaps fitting that it should conclude by glancing forward.

The main elements of the present scene are clear. The transition from a war economy to that of an armed peace has been made and made without disaster. But the so-called transitional period has proved longer, more arduous and more productive of problems than had been anticipated and each set of problems has, as it has arisen, called new *ad hoc* institutions into being to supplement the original 1944 conception of a single co-ordinated payments system under the control of the IMF. Now, looking back, it is easy to see that, in the last days of World War II, two methods of monetary reconstruction were created: one carefully and methodically planned, preparing the blueprint of a multilateral, control-free payments system to be established once the adjustments of the post-war period had been completed; the other growing naturally and progressively from the efforts of individual nations and groups of nations to solve problems as they came, produced a pattern of effort into which order and a sense of purpose later came, and which produced the outline of the present world economy. Superimposed

upon this, while not connected to it, waiting for an apparently endless transitional period to end, it is not surprising that the Bretton Woods system has become more symbolical than real. As one writer put it 'while the high monetary command of the IMF devoted itself to long-range strategy on a world-wide front, the field of battle was effectively left in the hands of the bilateral agreements which concretized the operating realities of monetary relations in Europe'.¹ These operating realities have led to a regional grouping of the countries of the world, which, as the warping influence of the dollar shortage on world payments lessens, still holds promise of further broadening to the ultimate goal of convertible currencies and multilateral payments. It may now be said that control of the international economy is decentralised and vested, not in two super-authorities governing trade and payments as in the 1944 conception, but in a number of functional regional agencies. Were we to succeed within the next few years in establishing the full convertibility of sterling and a measure of freedom from discriminatory import controls we would have achieved that desired condition which the draughtsmen of the 1944 plans had hoped for in five years. We should have reached it by a route more arduous and more circuitous than was anticipated but the achievement would be none the less real. This has been widely recognised. The failure of Britain's convertibility experiment in 1947, the continuing use of direct controls over trade and payments, the failure of ITO and the miserable record of the IMF might have spelled early ruin to the so-called 'collective approach' to a free multilateral world economy. That it did not do so is surprising. Yet in 1952, after a conference of Commonwealth prime ministers, Britain reaffirmed her adherence to the principle and in the next two years gave an earnest of her sincerity by bringing the pound to the threshold of convertibility. Now, in 1956, the drive has once more been halted. Convertibility is still acknowledged as the aim but it has become distant and shadowy. It is clear that the impetus of the collective approach has given way to a new assessment of the situation and prospects. For this, blame may be widely and equally apportioned. Britain, worried by fresh balance of payments difficulties and unable to accumulate reserves, is less sure of the direction in which her true

¹ Cf. *Money, Trade and Economic Growth*. New York, 1951. Chap. 3, 'Institutional Developments in the Intra-European Monetary System', Robert Triffin, p. 34.

interests lie. The United States, whose hot flush of enthusiasm brought the original plans into being, has turned from them with growing disillusionment and a realisation that in a dollar world other courses of action are preferable. Indeed the defection of the United States came early and, if a date may be assigned to it, 1950 when she buried the corpse of ITO is as good as any. Britain's attempt to revitalise the collective approach in 1952 was tolerantly but unenthusiastically received and the American Government's failure to implement the Randall Report of 1954 did much to communicate to the world at large the American change of heart. Other countries, lacking a lead, have been thankful to cluster together within whatever regional group best serves their interests.

It is possible to regard the present position in the international economy as the culmination of a historical process of breakdown and reconstruction. In 1931 with the fall of the gold standard, the old conception of a free international economy perished. We saw in the years between 1931 and 1939 the steady growth of direct controls over the balance of payments, first in Germany and Central Europe, at last in 1939 in our own country. We saw in the world as it emerged from World War II the accepted use by all countries (with the major exception of the United States) of bilateral payments agreements, discriminatory import controls and controls over foreign payments. Britain, the last country to succumb to controlled foreign trade, became in the postwar world its cleverest exponent. Thus we had a steady growth in the use of, and in the acceptance of, controlled trade and payments from 1931 right through the war and into the postwar period — a movement which reached its zenith in 1947, the year when European balances of payments were most disorganised, when the dollar problem looked most intractable, and when the failure to restore sterling as a convertible currency seemed to preclude the restoration of a world system of multilateral payments. This growth of controls was symptomatic of our failure to replace the gold standard by any adequate system of international adjustment; but our desire to do this was reflected in the growth of international co-operation and consultation on monetary matters whose history has been the subject of this book. To the extent that the tide of controls over payments is now receding some measure of achievement may be claimed. Since 1947 there has begun a new movement, a steady progress from bilateralism in foreign trade in the direction of freer payments — a move-

ment from straitened bilateralism to regional clearing. This began in Europe with the Multilateral Compensation Agreement of 1947 and was continued in 1948 and 1949 with the First and Second Intra-European Payments Agreements, all of which sought to replace the tangle of bilateral agreements which was strangling intra-European trade by a wider area of free payments. These efforts bore final fruit in 1950 with the establishment of the European Payments Union, which gave to the fourteen OEEC countries the status of a regional clearing group. This, together with the bridge established with the Sterling Area in the common membership by Britain of both groups, served to create freedom of payments within and between these two groups. So, in 1956, we find the international economy divided into great regional clearing areas, the OEEC countries of Western Europe, the Sterling Area and the many countries of the Transferable Account group, and the Dollar Area. Between the first two groups there exists a relatively free transfer of payments on the basis of sterling but between them and the Dollar Area there is no such transfer. This will only be established if sterling becomes once more a convertible currency. Thus, convertibility of sterling will, if achieved, complete a process of liberation, and, if the degree of convertibility is great, will restore a measure of freedom to the world payments system which it has not enjoyed since the days of the international gold standard.

What then may be the main features in the landscape of the international economy into which we appear to be passing? Briefly, there are three possible lines of development and we shall deal with these in turn.

The first possibility is, of course, that we shall not be able to proceed beyond our present position in the matter of convertibility of currencies and that we shall remain much as we are, in a state of suspended expectancy. This condition may be prolonged by any circumstance, or set of circumstances, which impedes the British government's programme to restore sterling as a convertible international currency. It could equally be brought about, and indeed perpetuated, by any premature rush for convertibility which, resulting in failure, was succeeded by a restoration of approximately the present conditions. The conditions which must be satisfied before convertibility is declared have already been reviewed and it is evident that the step entails major risks and

inescapable costs for Britain and the Sterling Area. It is clear that, for this reason and for the reason that convertibility once established must be maintained, the step should be delayed until the basic conditions are completely satisfied and the chances of success are strong. Better a slow but ordered advance than an impetuous rush followed by rout and ignominious retreat.

If, however, we assume that convertibility of the main currencies is achieved and maintained, what will be the nature of the resulting multilateral payments system? This system would not, as is sometimes assumed, be a rehabilitation of the sterling-dominated payments system of the nineteenth century. It would inevitably be a dual currency system, based on the dollar and on sterling, on New York and London. For sterling is not, nor is it ever likely to be again, capable of assuming the role which it filled until 1931. Many factors,— the relative weakness of Britain as a trading centre, the relative decline of British industry, the changes in the structure of world trade — have relegated it to a lesser position, while the waxing economic power of the United States and the overwhelming demand for dollars have given great significance to that currency. Now, and for a long time to come, sterling must merely fulfil the role of the most widely used of the weaker currencies. This dual-centred payments system would certainly be unstable, for the twin centres and their currencies would not be equal in strength. The dollar cannot, while the dollar shortage persists, be the sole international currency. Its scarcity, which demands its retention and precludes its immediate use, prevents this. It is a reserve rather than a trading currency. Sterling, on the other hand, seems unlikely to be able to withstand the strain to which, as second best among world currencies, it would be subject. Thus it seems that this dual system will present Britain with a dilemma for, if the dollar problem persists, sterling as the weaker partner will find itself subject to strains which may be difficult to bear, while, if the dollar problem yields to treatment, the dollar will speedily establish itself as the main international currency. It is hard to see how Britain can gain from being the uneasy pivot of such a system. As the weaker of the two centres her currency's external value would be the barometer for the economic weather of the world, hypersensitive both to her own prospects and those of the United States. Not only would she be required to sustain periodic speculative capital transfers, but also a derived demand for current sterling for

exchange into dollars. Moreover, she would no longer enjoy certain discriminatory advantages in the matter of her exports which she enjoys at present. It would be a tougher and sterner world for sterling to operate in than we knew before 1931. Subject to recurrent intensifications of the dollar problem such a system would be a severe strain on sterling as a currency and London as a financial centre. It is doubtful whether, with existing or foreseeable Sterling Area reserves, it could be sustained for long.

The deciding factor in this dilemma is of course the dollar problem. But, of this, who can foretell what will happen? The best that can be said is that there is no reason that, with time, effort and intelligence, this should not yield to counter measures. But to base future long-term policy decisions upon optimistic assumptions as to the future balance of payments of the United States would be folly indeed.

The prospect for the dollar shortage, the relative economic weakness of Britain and the growing strength of the United States all point to the unwisdom of prematurely establishing or seeking to establish such a dual system as we have described. Only if its establishment were accompanied by certain co-operative measures for its protection and maintenance should Britain agree to take the difficult position which would undoubtedly fall to her.

These two possibilities: that of remaining as we are or of establishing a fully multilateral free system in which much of the weight is borne by Britain are of course extreme limiting cases. It is unlikely that in practice events will take either of these two courses. It seems more probable that, before quitting the haven of convertibility, new steps will be taken in regional planning to establish mutual protection for the weaker members of the new multilateral economy or, if convertibility is long delayed, that new alternative measures for development within the regional framework will be proposed. Such compromises as these form our third line of development for the international economy.

The form of the European co-operative steps to cover convertibility have already been discussed¹ and need not detain us at this late stage. They provide for planned augmentation of international reserves so as to enable the European countries and especially Britain, to carry their responsibilities in a multilateral trade world. Providing that the European Monetary Agreement is not frozen in

¹ Cf. p. 301 above.

its present form but is regarded as establishing principles to be modified in the light of the conditions obtaining when it comes into force then it is a useful support for countries upon which the initial strains of a free economy would be placed. If, however, convertibility is delayed until, say, 1960 or after, the Agreement may well require drastic revision. Other forms of post-convertibility action have been proposed, notably the proposal for an Atlantic Payments Union and a proposal for the extension of EPU so as to include payments between the United States and OEEC countries within the purview of the scheme.¹ Each of these lines of action has its merits and defects, but none of the proposals has so far been worked out in any detail. All need careful thought and more precise formulation before judgements on their effectiveness can be formed.

It was inevitable that the long delay in achieving convertibility and the temporary failure of the collective approach should have led the stronger members of the European regional group to seek other means of widening the scope of their trade. The first symptoms of this movement became discernible when, after the conclusion of the European Monetary Agreement, emphasis in economic policy discussions moved from the field of payments to that of trade. At the Messina Conference in June, 1955 six countries — France, Germany, Belgium, Luxembourg, Holland and Italy — decided to take steps for the formation of a Customs Union in which they would abolish progressively over a period of 12–15 years all tariffs and quota restrictions between the constituent countries, allowing goods to circulate freely within the Union but protecting the whole area by the imposition of a tariff against imports from outside the area. A committee under the chairmanship of M. Spaak of Belgium has already issued a report on the progress which is being made towards this objective and in Brussels work on the preparation of a basic treaty is going forward. From this effort by the Messina powers much may come. Already a committee of OEEC is examining means whereby such other Western European countries as may wish to join may link themselves to the Customs Union in order to form a great free trade area. It is possible (and certainly it is desirable) that the United Kingdom may become part of this area. Should this great plan come to fruition it would provide over most of Western Europe a wide common market for the products

¹ For a discussion of the latter proposal see Alan Day's 'The Future of Sterling', chap. 13.

of European industry. It would provide in the demands of some 240 million people a basis comparable to that in the United States and the Soviet Union for the expansion of industry in which all the advantages of large-scale production and specialisation might be reaped. It would provide, moreover, a unique opportunity for the international division of labour and might do much to enhance the growth of industries otherwise constricted by national or limited overseas markets. It is as yet too early (September, 1956) to evaluate this grandiose conception. With careful planning it may open to European industry and to European peoples a dazzling prospect of expansion and prosperity. Certainly it will place many of the problems we have discussed in this book in a new light. The dollar problem would require re-assessment and new payments arrangements in Europe would no doubt be stimulated by the reorientated trade structure which would result. Whether the collective approach would be superseded and permanently set aside or whether it would be reconciled with the new regional arrangements it is impossible to say at this stage. Certainly its usefulness would have to be viewed afresh in the light of new conditions. The work of negotiating and establishing the European free trade area will be difficult and long but the fact that it is being attempted is proof of the energy which vitalises the European movement for economic co-operation.

Such then are the possible lines of development for the international economy during the coming decade. It remains to comment upon the role of the international monetary institutions in such conditions as we have postulated. It will be apparent that in these possible lines of development which the international economy may follow there will be in the future, as there have been in the past, two basic problems: that of evolving a mechanism which will preserve payments equilibrium at high levels of employment between countries and groups of countries, and that of providing a form of international liquidity sufficient in amount and appropriate in distribution for the scale and rate of growth of world trade.

The failure of the Bretton Woods system has been in great part the result of the inability of its guardians to find adequate solutions to these two problems. While the IMF has made useful peripheral contributions to world payments, its inability to provide the elements of a real adjustment mechanism has prevented its moving to the central position in the world economy for which it was intended.

It is already late in the day but, if the IMF is ever to be anything more than a 'talking shop' in which the delegates of Britain and the United States argue and recriminate for the diversion of the delegates of Honduras and Thailand, then it must move quickly to meet the problems which we have outlined. Much time has been spent in these pages in describing how, in the writer's opinion, it may best do this. It is necessary only to reiterate briefly. In order to provide some element of adjustment as between countries the Fund must declare itself willing to approve suitable arrangements for flexible exchange rates. This would end the system of so-called 'managed flexibility' which is ill-suited to adjust balances of payments, least of all in a world of fully-employed economies. It would also provide a cushion for the support of those currencies which may have to undergo the initial strains of convertibility. In the provision of international liquidity the Fund can also play a useful part for, even with present quotas, it has a large holding of dollars. These it should make available for the support of currencies which are to be made convertible, not through vague promises but through firm special allotments to be drawn upon at will in case of need.¹ In a longer term sense the Fund must seek to enhance its contribution to the liquidity problem through a revision of its quotas.

It is always easier to build upon the basis of existing institutions than to pioneer new ones. For this reason it is tempting to try to rehabilitate the Fund and give it a position of prominence in the new world economy. But we must beg leave to doubt whether this can now be done. Whichever of the above forms the international economy may take it will be a very different economy from that in which the IMF was designed to function. For ten years the Fund has striven within the stranglehold of its own constitution to establish itself in a world far different from that conceived by its founders — a world not of multilateral trade but of bilateral trade and regional groupings; a world not threatened by deflation and economic stagnation but of buoyant economies and recurrent inflations; a world seeking to adjust itself not only to the impact of war and its aftermath but to structural changes in trade on whose action the postwar problems were superimposed. The Fund has not been able to adjust itself to these conditions and, failing in its intended

¹ For example the Fund might offer a large dollar loan to the proposed European Fund.

rôle as an international organisation, it has become a mere mouth-piece of American economic power. No doubt the Fund will continue to provide the services which it has established. It may in time add to them and (as the BIS has done) be of use in ways other than those for which it was designed. The Bank will doubtless continue to operate efficiently and, supplemented by the new IFC, it has a valuable contribution to make.

There is little cause for despondency if the original conception of co-ordinated economic co-operation of 1944 has gone somewhat awry. Such despondency would only be justified if the Bretton Woods institutions had to be declared a total loss and if ordered planning had given way to international monetary anarchy. Such has been far from the case. Some aspects of the Fund and Bank have proved their worth and, more important, the principle of international monetary co-operation has become an accepted part of the world economic scene. The frailty of one set of organisations in dealing with harsh conditions has enduced the creation of others more suitable, which have achieved international usefulness and acceptance. It is perhaps an earnest of the spirit in which international monetary problems are tackled, a spirit far different from that of the 'thirties, that while great differences of opinion exist as to the method by which we should approach the world economy of the future, none questions that its framework will be mutually agreed.

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